



Australian Government
Productivity Commission

Will Asian Mercantilism Meet its Waterloo?

Martin Wolf

Richard Snape Lecture
14 November 2005
Melbourne

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RICHARD SNAPE 1936 – 2002

Richard Hal Snape was Deputy Chairman of the Productivity Commission and Emeritus Professor of Monash University. He was a Board Member of the Australian Research Council, Fellow of the Academy of the Social Sciences in Australia and a Distinguished Fellow of the Economic Society of Australia.

MARTIN WOLF

Martin Wolf is associate editor and chief economics commentator at the Financial Times. He was awarded the CBE (Commander of the British Empire) in 2000 for services to financial journalism. He is a visiting fellow of Nuffield College, Oxford University, and a special professor at the University of Nottingham.

Mr Wolf joined the FT in 1987 as chief economics leader writer and became chief economics commentator in 1996. Mr Wolf has been awarded numerous prizes for excellence in journalism and, among other publications, is the author of *Why Globalisation Works* (Yale, 2004).

He obtained a Master of Philosophy from Oxford University in 1971. He has previously held senior positions at the World Bank in Washington DC and at the Trade Policy Research Centre, London.

Foreword

Richard Snape capped a long and distinguished career as Professor of Economics at Monash University with a new and accomplished career at the Industry Commission and then as Deputy Chairman of the Productivity Commission. In the eight years that he spent at the Commission before his untimely death in October 2002, he played a pivotal role in overseeing our research program, as well as participating in major public inquiries.

This is the third in a series of lectures in memory of Richard Snape. With Richard's own interests and high standards in mind, the lecture series elicits contributions on important public policy issues from internationally recognised figures, in a form that is accessible to a wide audience.

Martin Wolf, this year's lecturer, is a worthy successor to Max Corden and Anne Krueger. Martin Wolf has attained a pre-eminent position among economic journalists worldwide, drawing on diverse experience in policy analysis at key institutions where he also made an important contribution. In addition, Martin shares with the previous lecturers a long association with Richard Snape, who I am sure would have been pleased at his involvement and with his choice of topic.

I am grateful to Martin Wolf for agreeing to come to Australia, notwithstanding pressing claims on his time, to present the Richard Snape Lecture for 2005.

Gary Banks
Chairman

November 2005

Richard Snape

I had the honour of knowing Richard Snape for almost 25 years. His untimely death robbed the world of one of its most penetrating, practical, astute and honourable applied economists. I found his company unfailingly delightful and his analysis unfailingly helpful. He was hugely influential in his home country. Indeed, he is one of the economists who helped persuade Australia to embrace the structural economic reforms that have borne such wonderful fruit in recent years. But his influence in the wider world was hardly less significant. I concur completely with Anne Krueger, last year's lecturer, who remarked that:

Richard's reputation as an academic and policy adviser was truly global. His research was known and respected in academic communities around the world. The time he spent at the World Bank, with the GATT and the WTO, and in Stockholm and elsewhere was valued by his colleagues there; and by those of us who benefited from all that Richard produced.

I hope it is in keeping with Richard's memory that this lecture was largely written under the influence of James Meade's idea of 'internal and external balance', the 'Salter-Swan' or 'Australian' model of the balance of payments and Max Corden's concept of 'exchange rate protectionism'. Max was, of course, my teacher of international economics at Nuffield College, Oxford, between 1969 and 1971. It seems appropriate that my analysis of the global balance of payments and the threat its evolution poses to the maintenance of the open trading system in which Richard believed so firmly rests largely on the work of three Australian economists and the British economist who was the teacher of my own teacher. This lecture allows me to pay tribute, therefore, not just to Richard himself, but to Australian international economics and Max Corden. I hope Richard himself would have approved.

Martin Wolf
November 2005

Will Asian mercantilism meet its Waterloo?

If you owe your bank a hundred pounds, you have a problem. But if you owe a million, it has. (John Maynard Keynes)

Things that can't go on forever, don't. (Herbert Stein)

[O]ver the past decade a combination of diverse forces has created a significant increase in the global supply of saving—a global saving glut—which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today. (Ben Bernanke¹)

Long-term rates have moved lower virtually everywhere. Except in Japan, rates among the other foreign Group of Seven countries have declined notably more than have rates in the United States. Even in emerging economies, whose history has been too often marked by inflationary imbalances and unstable exchange rates, access to longer-term finance has improved. (Alan Greenspan²)

Ben Bernanke, nominated by George W. Bush, to be the next chairman of the Federal Reserve, and Alan Greenspan, the huge figure that still holds the most important position in central banking have been pointing, in recent months, to some puzzling features of the contemporary world economy. Mr Greenspan has even gone so far as to describe one aspect of this — today's low nominal and real interest rates — as a 'conundrum'. I wish to argue that there are, in fact, two conundra — the low real interest rates and the scale of the US current account deficit. Moreover, I concur with Mr Bernanke that they have a single underlying cause, namely, the excess of savings over investment in much of the rest of the world. Indeed, I had been arguing this in my columns for the *Financial Times* well before Mr Bernanke's elegant exposition last March.³

¹ Ben Bernanke, 'The Global Saving Glut and the U.S. Current Account Deficit', March 10 2005, www.federalreserve.gov.

² Alan Greenspan, 'Remarks by Chairman Alan Greenspan' June 6th 2005, www.federalreserve.gov.

³ My recent articles in the FT on this theme include: "Our currency, but your problem": the dollar's delicate balancing act', 1st March 2004, 'Imbalances sweep across the Pacific', 19th November 2004, 'The world has a dangerous hunger for American assets', 8th December 2004, 'Wanted: an Asian solution to the America's debt trap', 22nd December 2004, 'Global imbalances will require global solutions', 27th April 2005, 'The paradox of thrift', 13th June

In what follows I will begin with the twin conundra and the underlying explanation for both: the savings glut in much of the world. I will then turn to the global picture of savings and investment, thereby identifying the principal surplus regions. It will turn out that declining investment rates are more important than rising savings as an explanation for the surplus. Keynes would have called this a lack of ‘animal spirits’. Behind the weak investment has been a series of asset price crashes: notably in Japan in the early 1990s, the Asian financial crises of 1997–98 and the global stock market crash after 2000. But the recent rise in the price of oil has also played a part, by shifting income from spender to savers across the globe.

The discussion then turns to the global balance of payments and, in particular, the policies that help sustain the savings surpluses. It turns out that about half of the overall surplus is in Asia, while the remainder is divided roughly equally between the oil exporters and western Europe. The United States is not the only significant deficit country. But it is much the most important. Its deficit absorbs roughly three-quarters of the excess savings of the surplus regions.

What is special about the Asian region — both Japan and the emerging economies — is that these countries are intervening heavily in exchange markets: astonishingly, close to half of the foreign currency reserves in the world — a sum of nearly \$2,000 billion — has been accumulated in the last three and a half years. Their surpluses are, I will argue, the result of deliberate policy, not just of voluntary private behaviour. For this, there are several explanations. Among the most important is ‘exchange-rate protectionism’ — or, in an older terminology, mercantilism, by which is meant an overwhelming focus on exports and a strong current account position. In recent years, a number of economists associated with Deutsche Bank have referred to this as a ‘new Bretton Woods’.⁴

Then I will turn to the US response. I will argue that the United States has to accommodate the rest of the world’s growing desire to accumulate US assets. At the real exchange rate dictated by the behaviour of the rest of the world, internal balance requires a huge surplus of spending over income or, in terms of the Salter-Swan model, of demand for tradeables over supply. The US monetary and fiscal authorities have to follow the policies that will offset the drain in the circular flow

2005, ‘Flowing uphill’, 27th June 2005, ‘Multilateral leadership can right the ship’, 28th June 2005 and ‘Capital flows must change course’, 28th August 2005.

⁴ See Michael P. Dooley, David Folkerts-Landau and Peter M. Garber, ‘Savings Gluts and Interest Rates: the Missing Link to Europe’; National Bureau of Economic Research Working Paper 11520, July 2005, www.nber.org, ‘The US Current Account Deficit and Economic Development: Collateral for a Total Return Swap’, National Bureau of Economic Research Working Paper 10727, August 2004, www.nber.org, ‘Direct Investment, Rising Real Wages, and the Absorption of Excess Labour in the Periphery’, National Bureau of Economic Research Working Paper 10626, July 2004, www.nber.org.

of income that is coming from the current account deficit. In aggregate, US spending has to exceed potential output by about 6–7 per cent of GDP.

The final section asks how this might end. There are, I will argue, good reasons for both sides to continue in the present direction. But there are also sizeable risks. Perhaps the most obvious is an explosive increase in US protectionist pressure in the next cyclical downturn, if not sooner. Is it desirable, I ask, for a country as big as China to follow the mercantilist policies of previous fast-growing Asian economies? I will suggest that it is not. There should, instead, be a move towards more flexible exchange rate regimes and, as a corollary, greater attention to increasing domestic demand. If that does not happen quite soon, it may prove at the least difficult, if not impossible, to sustain the open world trading system in which Richard Snape believed so strongly.

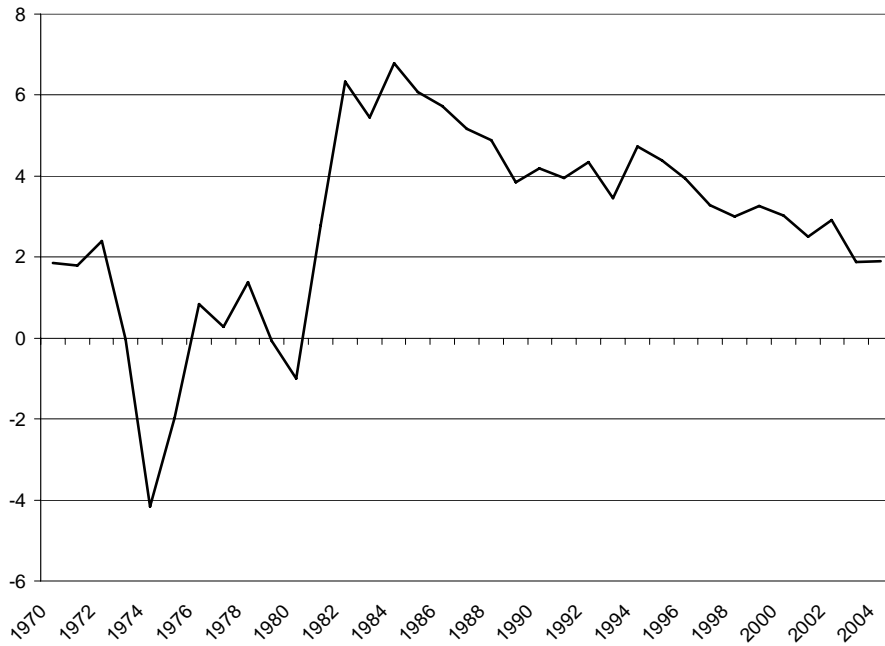
The conundra

Figures 1 and 2 both give essentially the same picture: real interest rates are currently extremely low. An IMF estimate of global long-term real interest rates, published in the April *World Economic Outlook*, suggests that they were then running at about 2 per cent (figure 1). The only period in the last 35 years when they were lower was the 1970s, an era of unexpected inflation. These inevitably rough estimates are given strong support by data on index-linked government bonds in the United Kingdom and United States (figure 2). Real interest rates have collapsed to as low as 1.5 per cent in these cases.

Note that we are talking here of real interest rates, not nominal ones. Thus, the decline in global inflation cannot be the cause. Note, too, that this is not a period of recession or weak economic growth. On the contrary, the world economy has been growing quite healthily in recent years. Even at market prices, the world economy grew 4 per cent in 2004 and is forecast by the International Monetary Fund to grow 3.1 per cent this year.

Low real interest rates are just the first puzzle. The second one is the explosive rise in the US current account deficit (figure 3). As will be seen, the rise in the deficit has been almost continuous since the early 1990s. But it accelerated after the Asian financial crisis in 1997-98 and again after the post-bubble slowdown in 2001. Almost an eighth of the rest of the world's gross savings are, as a result, now being exported to the United States.

Figure 1 **World real long-term interest rate**



Data source: IMF World Economic Outlook, April 2005.

Figure 2 **Real interest rates (index-linked bonds)**

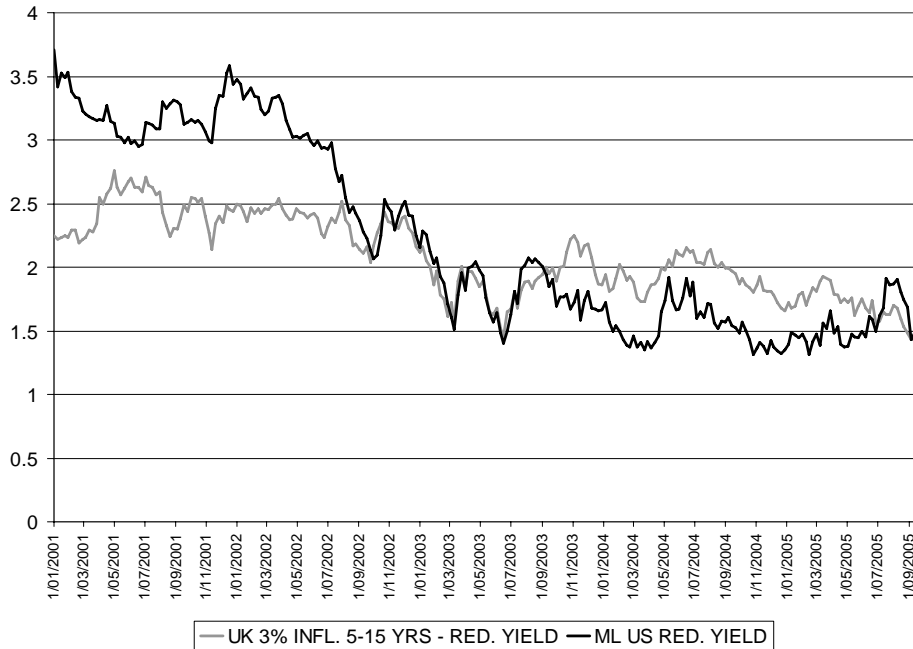
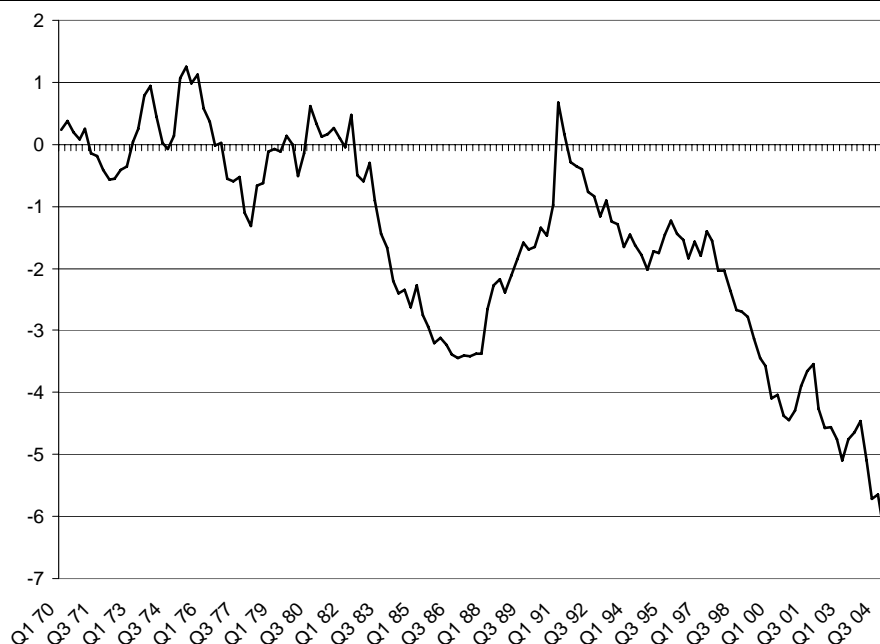


Figure 3 **US current account balance (per cent of GDP)**



Savings and investment across the globe

How then is one to explain these twin phenomena? The obvious answer is that the rest of the world finds itself with more savings than it can profitably employ at home, even at low real interest rates. It is also choosing to put a large part of this surplus in the United States. Since 2000, the vast bulk of this money has been put in dollar bonds, which, it should be noted, offer low nominal and real interest rates and provide no hedge against a decline in the external value of the dollar. The US external deficits are not crowding out investment in the rest of the world. Rather the rest of the world's excess savings are crowding in US deficits.

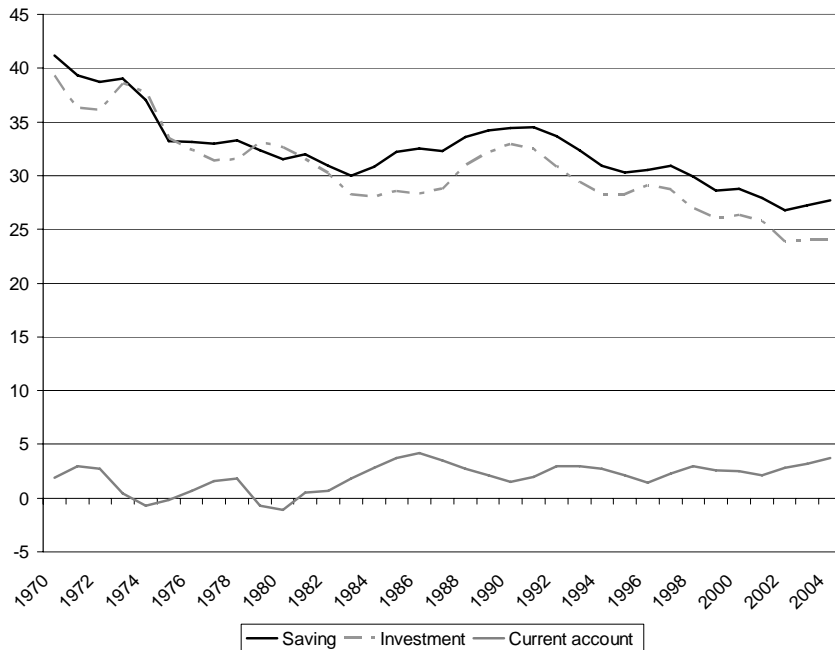
If we look more closely at the principal surplus regions, we find a complex picture. In some cases, savings and investment rates have both risen; in others savings have risen and investment has fallen; and in some cases, savings and investment have both fallen. But the pattern always ends up with an increase in the gap between savings and investment.

Figures 4 to 13 give us the overview we need.

In the case of Japan (figure 4), investment has been falling since 1990, as a share of GDP. So has saving, but this is largely because of the big fiscal deficits. The surplus of savings over investment in the private sector is about 9 per cent of GDP, predominantly in the corporate sector. This is offset by Japan's government dis-

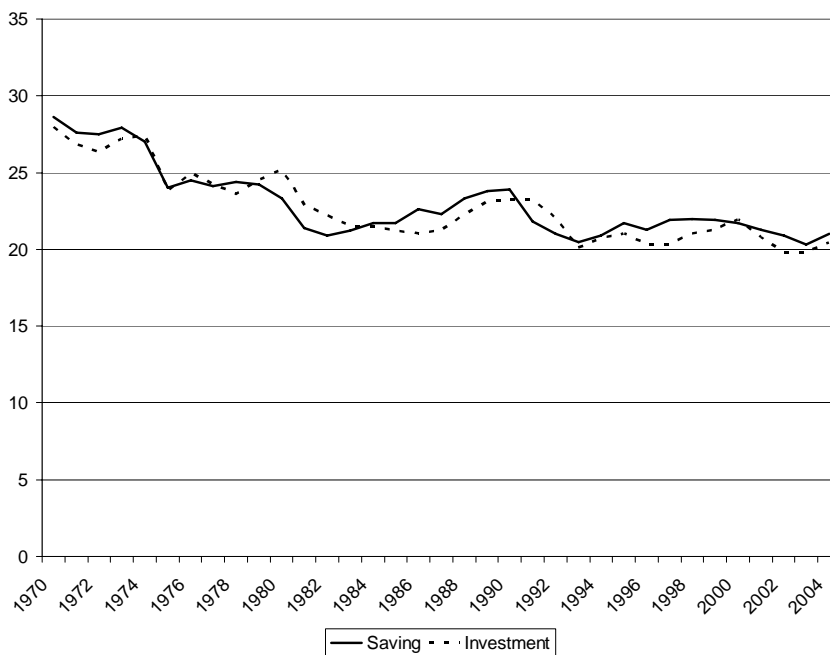
saving and the current account surplus. Meanwhile, in the Eurozone, savings and investment have been in closer balance, but the region has tended to generate a small surplus in recent years (figure 5).

Figure 4 Savings and investment in Japan (per cent of GDP)



Data source: IMF, WEO September 2005.

Figure 5 Savings and investment in the Eurozone (per cent of GDP)

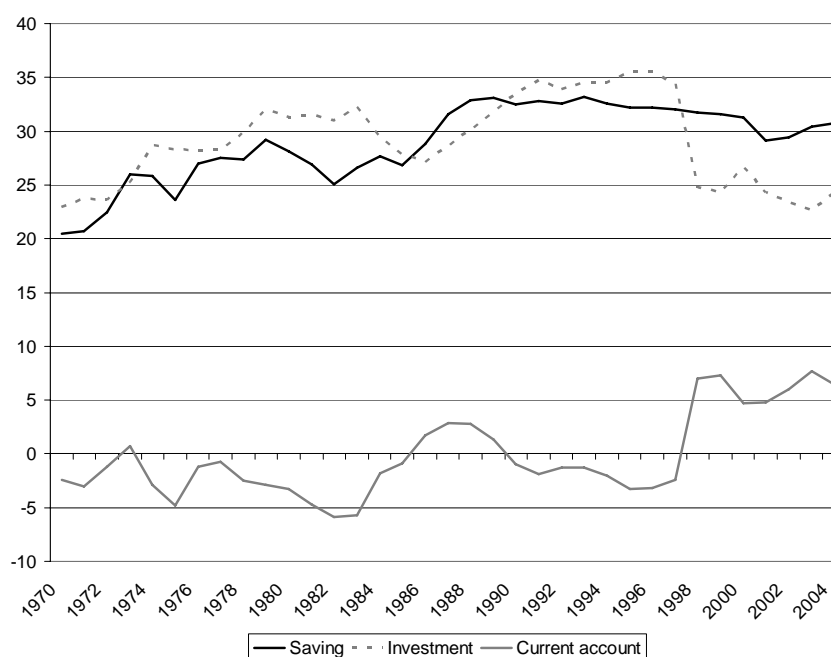


Data source: IMF, WEO September 2005.

Now let us look at the East Asian emerging market economies (other than China). These have had consistently high savings rates of about 30 per cent of GDP, but suffered a collapse in investment rates in 1997-98, which has not been reversed (figure 6). China, however, has had soaring investment, which has reached the stupendous level of 45 per cent of GDP, but savings have risen even faster (figure 7). While it would be interesting to look at the underlying composition of savings in all these cases, space and time forbid. But the pattern in China is so important and extraordinary that it deserves special examination (figure 8). Contrary to the general view, it is not household savings, high though they are, that are driving China's soaring savings rate, but the profits of the enterprise sector and public savings. Both are policy decisions: the former because the government is not taking and spending the dividends from state-owned enterprises to which it is entitled; and the latter because it is the direct result of government decisions.

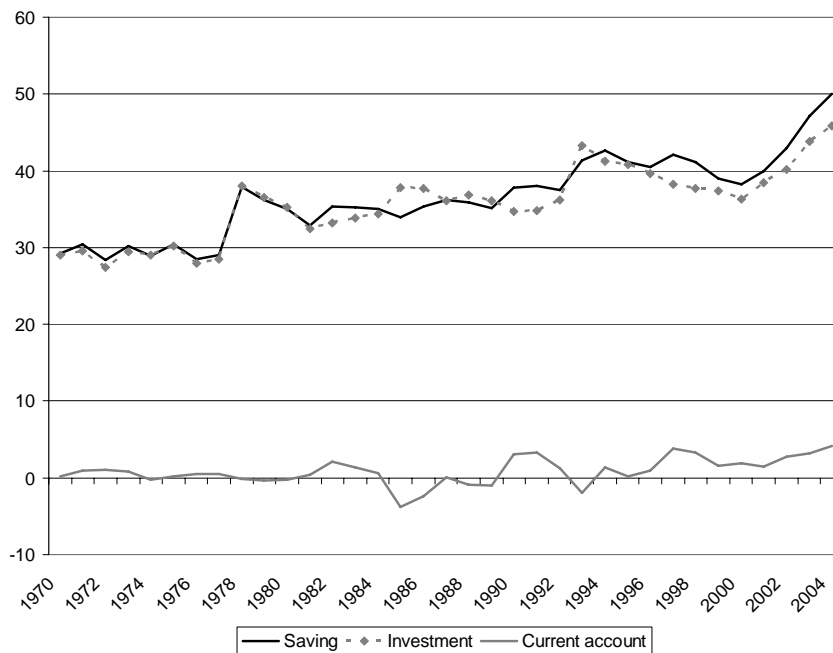
Meanwhile, both the oil producers and all other emerging market economies are also running surpluses of savings over investment (figures 9 and 10). The surpluses of the former are, as one might expect, recent. The surpluses of the latter are also relatively recent. The overall picture, in any case, is of savings surpluses almost everywhere. Indeed, the only regions to be running significant deficits are central and eastern Europe and the 'Anglosphere', particularly the United States, the United Kingdom and Australia. Overall, moreover, emerging market economies are capital exporters and the advanced countries are capital importers (figure 11).

Figure 6 Savings and investment in East Asian emerging economies (per cent of GDP)



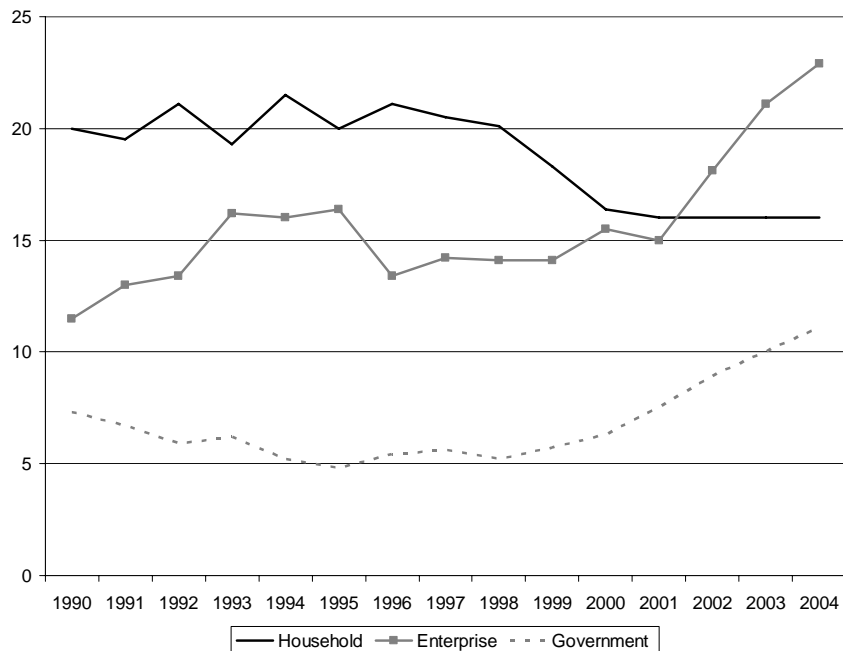
Data source: IMF, WEO September 2005.

Figure 7 Savings and investment in China (per cent of GDP)



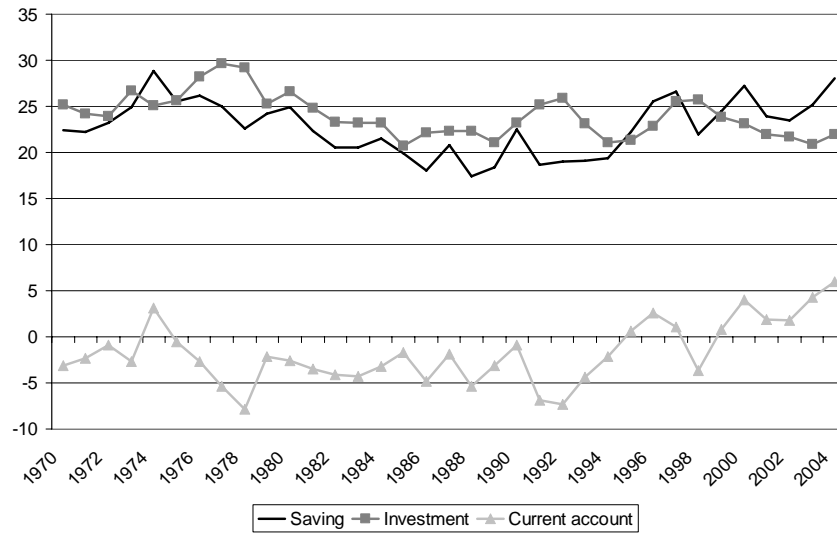
Data source: IMF, WEO September 2005.

Figure 8 Sources of Chinese savings (per cent of GDP)



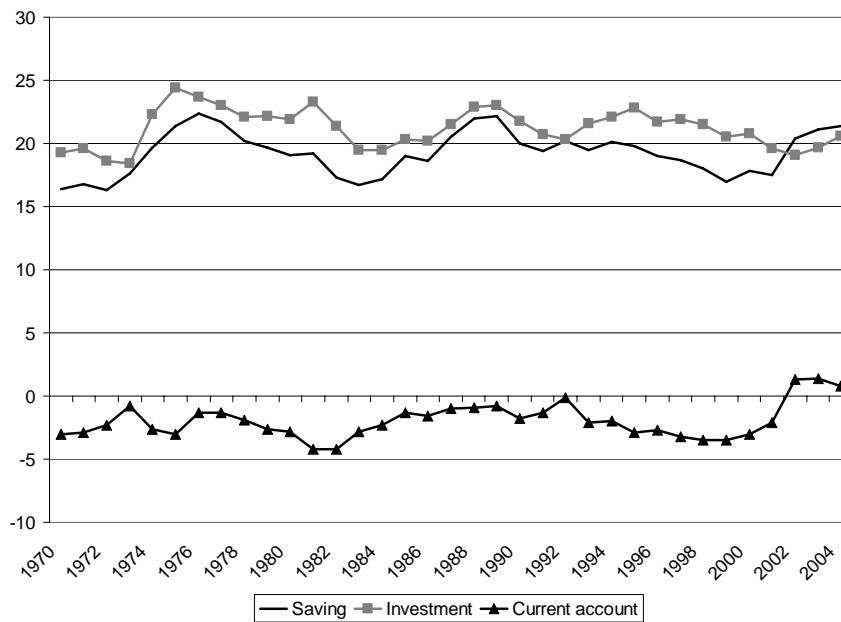
Data source: IMF, WEO September 2005.

Figure 9 Savings and investment of oil producers (per cent of GDP)



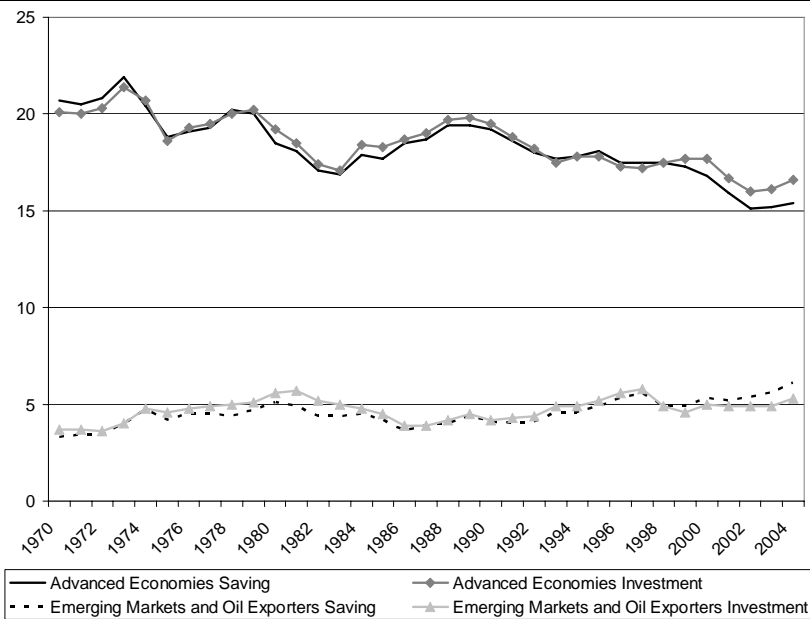
Data source: IMF, WEO September 2005.

Figure 10 Savings and investment in other emerging market economies (per cent of GDP)



Data source: IMF, WEO September 2005.

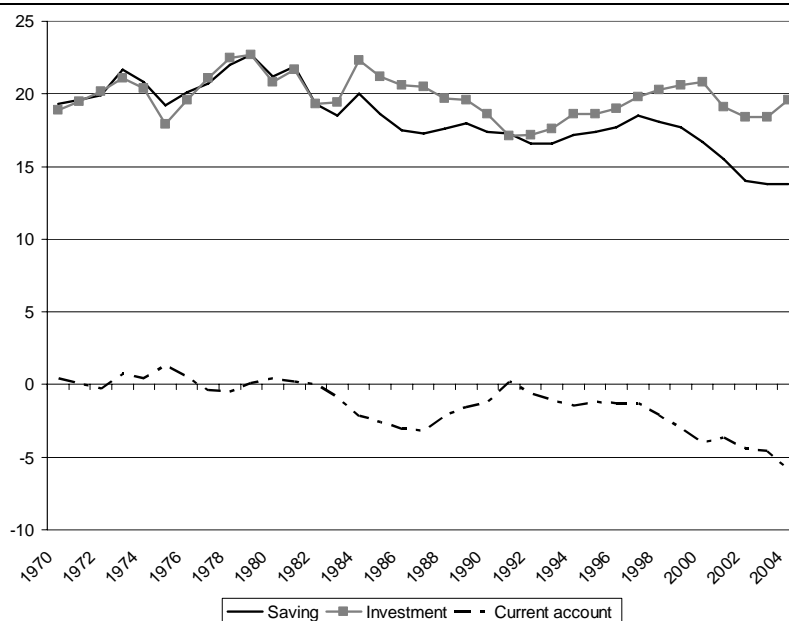
Figure 11 Savings and investment (per cent of world GDP)



Data source: IMF WEO September 2005.

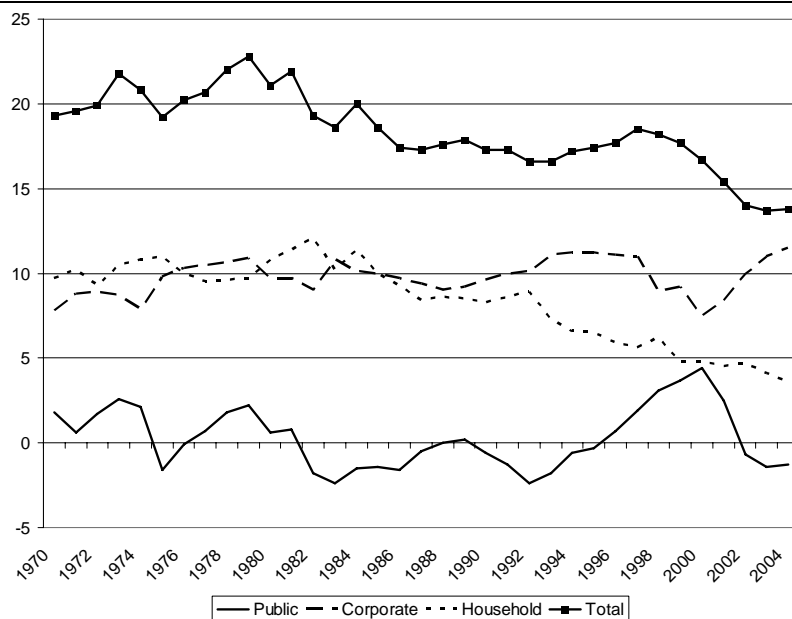
Now turn to the United States, which is absorbing nearly all of these surpluses (figure 12). The principal counterpart of the growing shortage of savings is a decline in the savings rate rather than a rise in the investment rate. The drivers of this decline in US savings are falling household and public sector savings (figure 13). As is true in most of the world, corporate profits and so savings are remarkably high in the United States at present.

Figure 12 Savings and investment in the USA (per cent of GDP)



Data source: IMF, WEO September 2005.

Figure 13 Sources of savings in the USA (per cent of GDP)

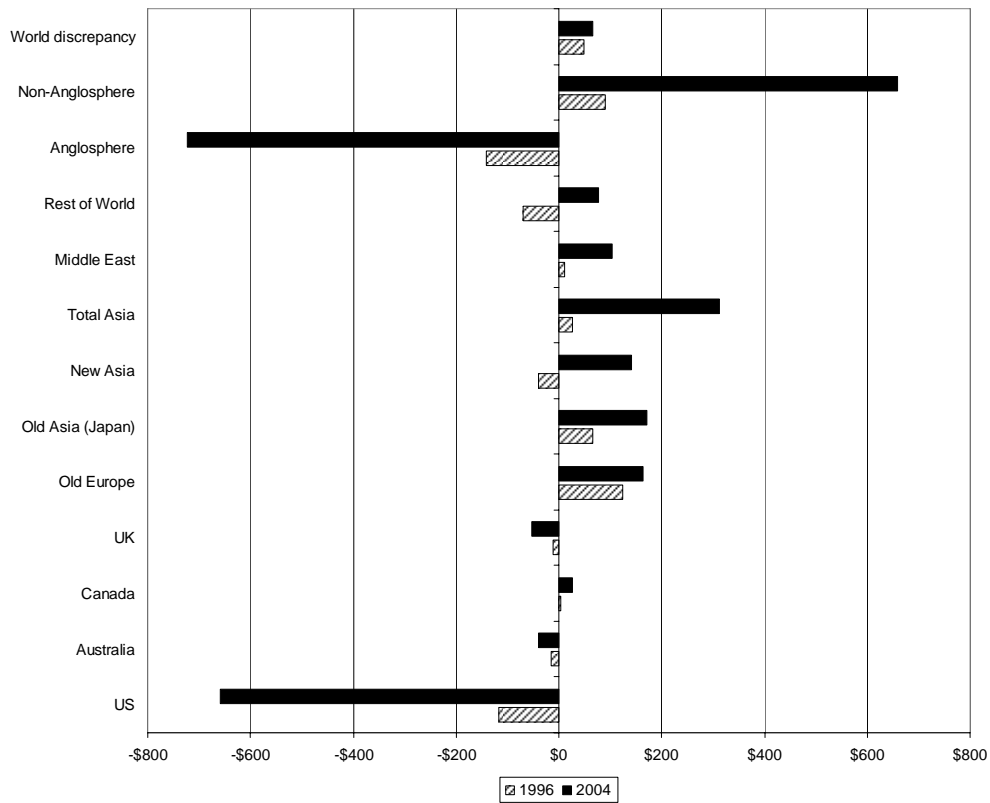


Global balance of payments

The excess of savings over investment must show itself in the global pattern of current accounts and so, indeed, it does. As we can see in figure 14, the shifts have been very large. But the principal shifts have been in emerging economies, on the one hand, and in the United States, on the other. Between 1996 and 2004, the swing in the aggregate current accounts of the former was the massive sum of \$421 billion. The counterpart swing of the United States was \$541 billion. Thus, almost 80 per cent of the counterpart to the increase in the US deficit has been the swing of emerging market economies in current account surplus.

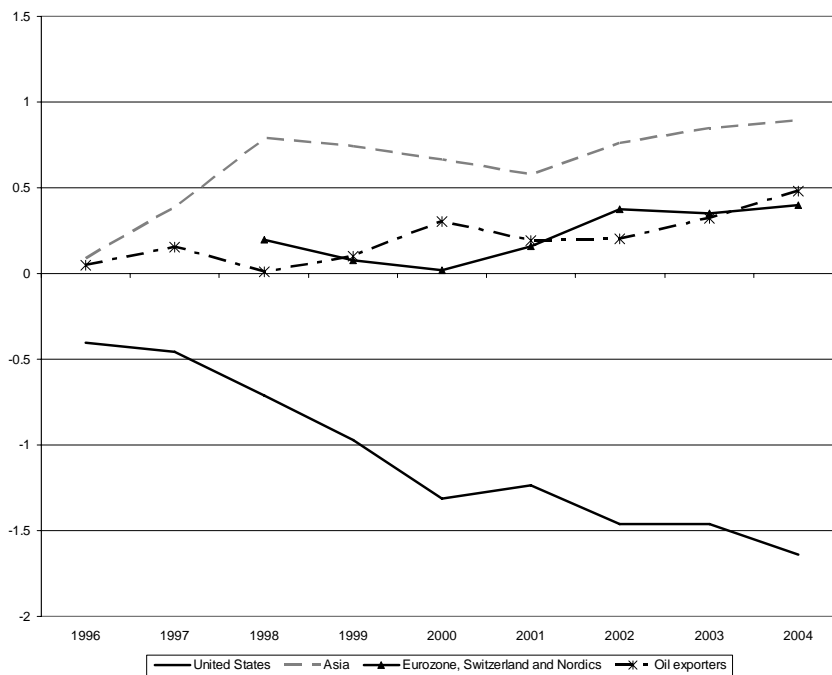
Figures 15 and 16 give the same picture, but, rather more interestingly, as a share of global GDP. Asia generates roughly half of the surplus, Europe and the oil exporters about a quarter each. The Asian surplus, in turn, is divided roughly equally between Japan and emerging Asia. The big recent surge in the surplus of the oil exporters is evident. But so is the big shift in Asian emerging market economies, between 1996 and 1998 and again, with rise of the Chinese surplus, after 2001.

Figure 14 Global balance of payments after the crises (1996 and 2004)



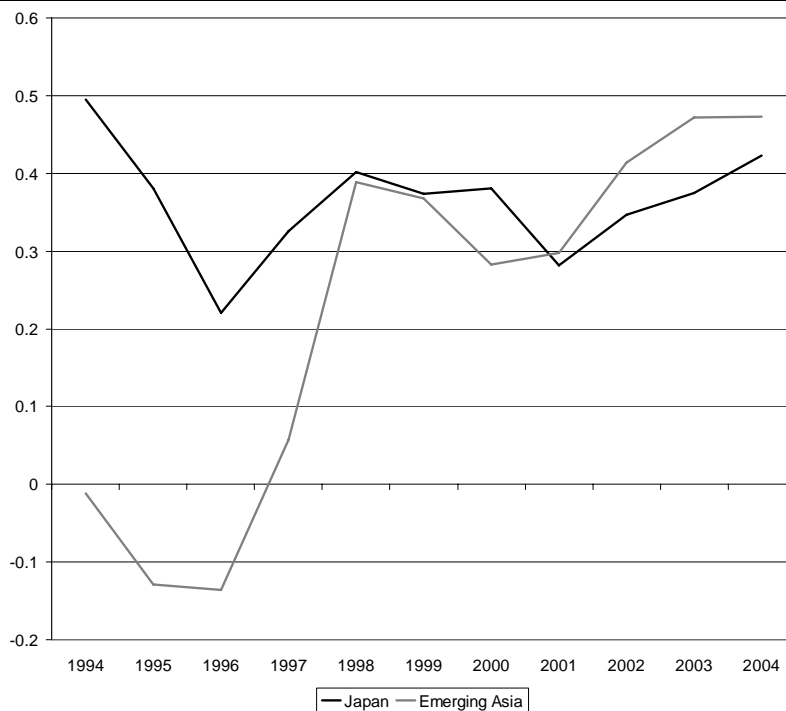
Data source: IMF, World Economic Outlook, April 2004.

Figure 15 The emergence of global 'imbalances' (per cent of world GDP)



Data source: IMF.

Figure 16 Asia's role as a surplus region (per cent of world GDP)



Data source: IMF.

Now look at figures 17, 18 and 19. Here comes the heart of our story. The current account deficits swung into surpluses, as we already know. But the inflows of foreign direct investment also continued. These huge surpluses of foreign exchange had to be offset by something and they were: massive foreign currency accumulation to prevent movement of the exchange rates. If this had not happened, the current account surpluses would have disappeared, on the (highly plausible) assumption that the flow of capital would have continued, particularly to China. Of course, that would also have required changes in monetary and fiscal policies in the emerging market economies.

Even though China is forecast to generate only about a quarter of the current account surplus of emerging market economies in 2005, it represents the most intriguing story. This year, for example, the Chinese current account surplus is forecast at \$116 billion. To this must be added a possible inflow of perhaps \$70 billion in foreign direct investment and a speculative inflow of \$40 billion, or so. That then is balanced by reserve accumulations of perhaps \$230 billion, which is well over 10 per cent of GDP. The private sector then is trying to drive China into current account deficit. The government is, in turn, trying very hard to prevent this from happening.

Figure 17 Balance of payments of emerging market economies (\$ billion)

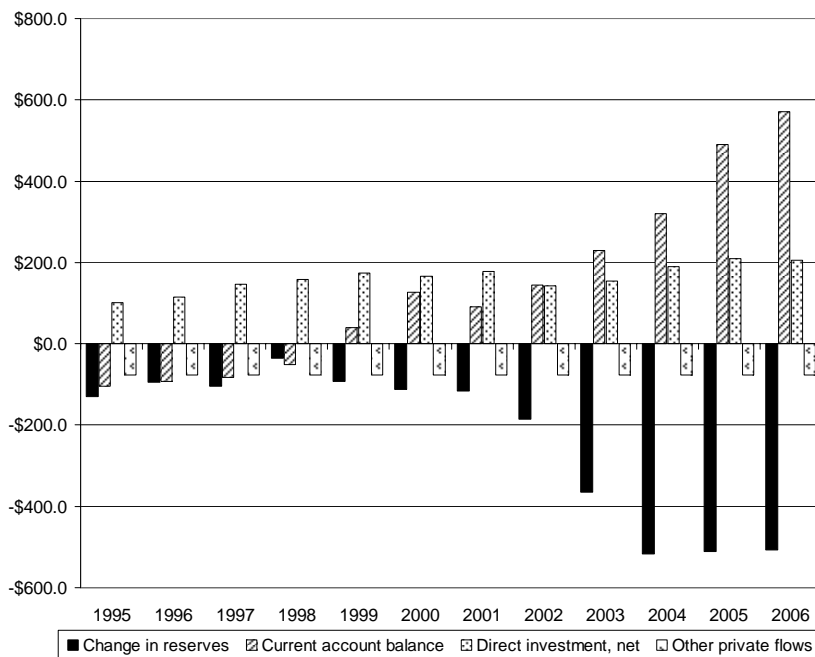
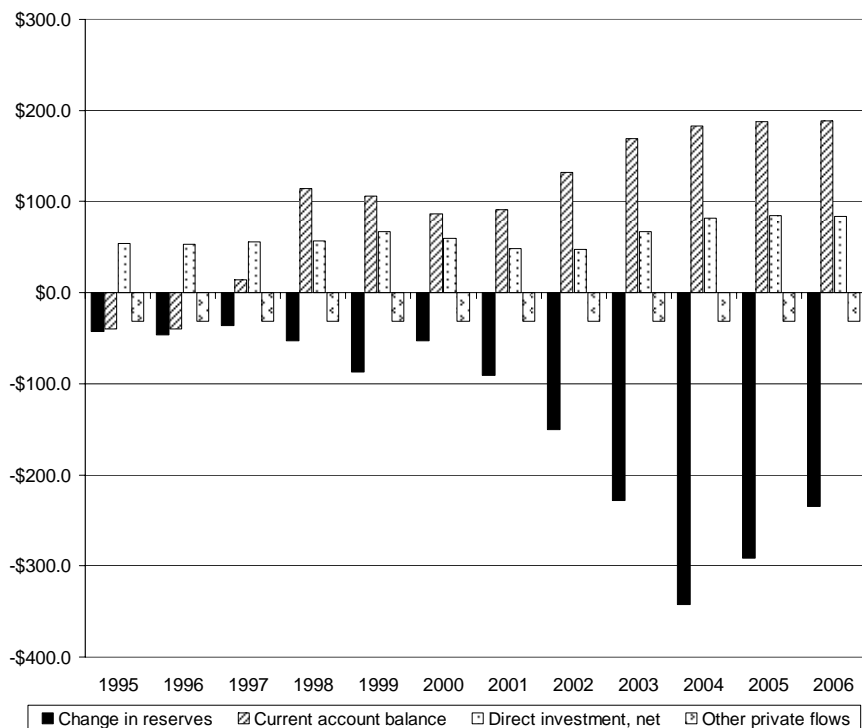
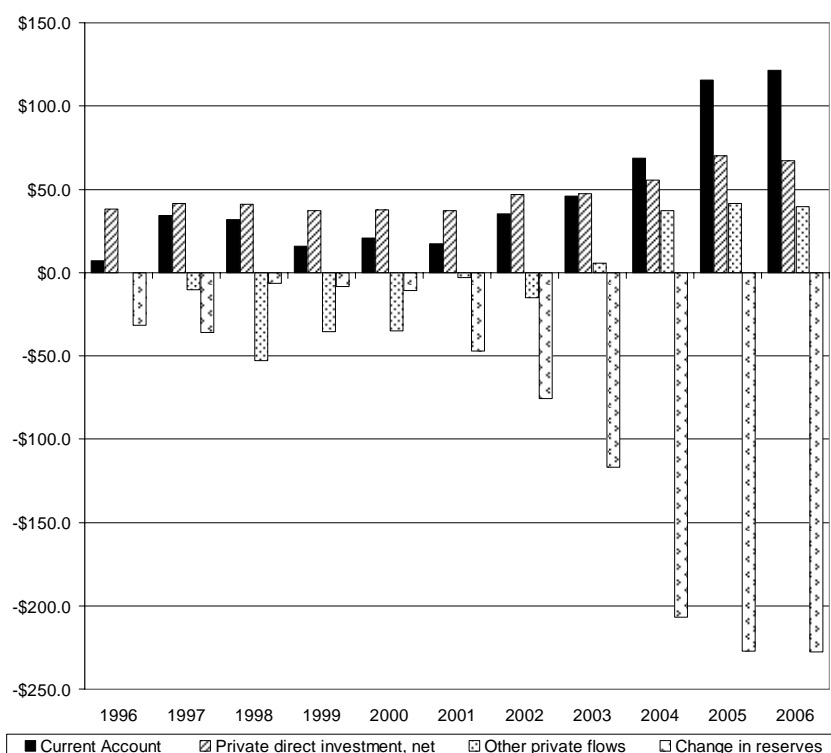


Figure 18 Balance of payments of emerging Asia



Data source: IMF.

Figure 19 China's balance of payments (\$ billion)



What is more they are succeeding, as figure 20 also shows. The emerging market economies have been highly successful in preventing large movements in their exchange rates. It is, as the chart shows, perfectly possible to ‘buck the market’, provided one is trying to prevent one’s currency from appreciating. Most Asian countries have succeeded in keeping their currency down. The price, of course, has been massive increases in foreign currency reserves (see figure 21). By July China’s had reached \$733 billion, which is more than a third of GDP. Between December 2001 and July 2005, China’s reserves rose by \$520 billion, Japan’s foreign currency reserves by \$430 billion, Taiwan’s by \$130 billion, South Korea’s by \$100 billion and India’s by \$90 billion. We do not know the precise composition of these official reserves, but the bulk was certainly in US dollars.

Again, theory suggests that, in the long run, the monetary effects of such accumulations of foreign currency reserves will generate overheating, inflation and so, ultimately, a depreciation of the real exchange rate. In fact, this is not happening. The reserve accumulation is being sterilised in a number of ways. As figure 22 shows, the scale of sterilisation of the direct monetary effects of reserve accumulation has been very large. What makes this operation relatively straightforward is the low level of domestic interest rates, which eliminates the budgetary cost of intervention altogether. In the long run, however, it is likely that sterilisation will fail. Current savings rates also seem implausibly high in China.

When spending starts to grow, inflationary pressures are likely to emerge. The real exchange rate will then begin to adjust. But that is certainly not happening at the moment.

Figure 20 **Currency movement against the US dollar (31 December 2002 – 20 October 2005)**

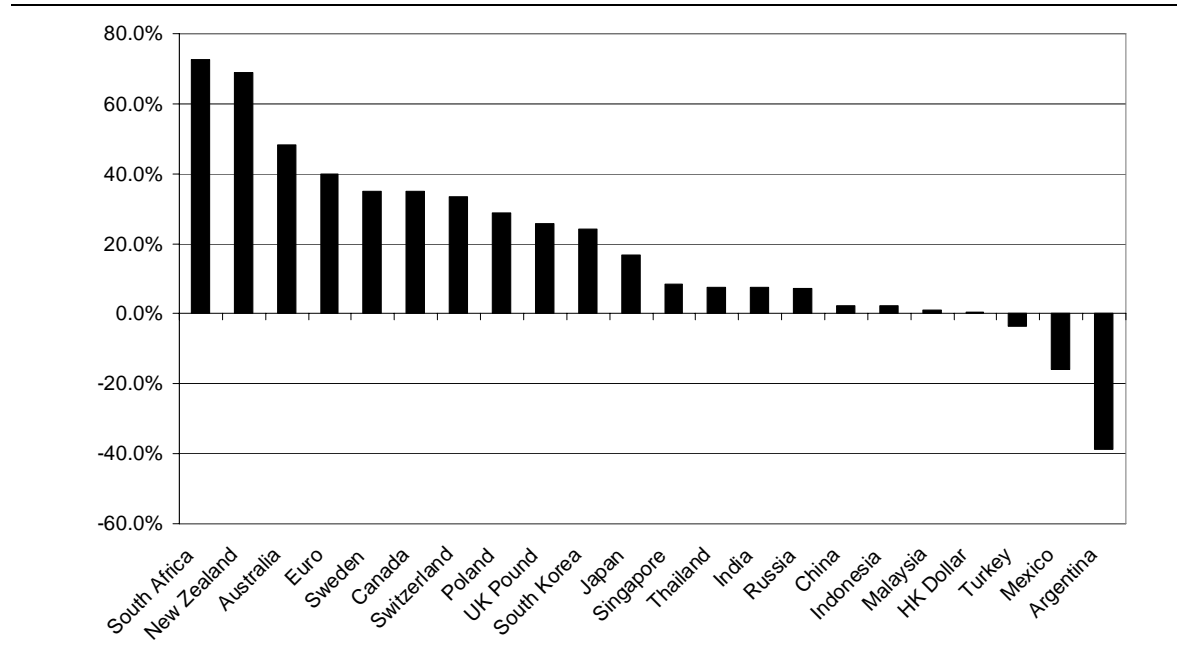


Figure 21 **Foreign currency reserves (\$ billion)**

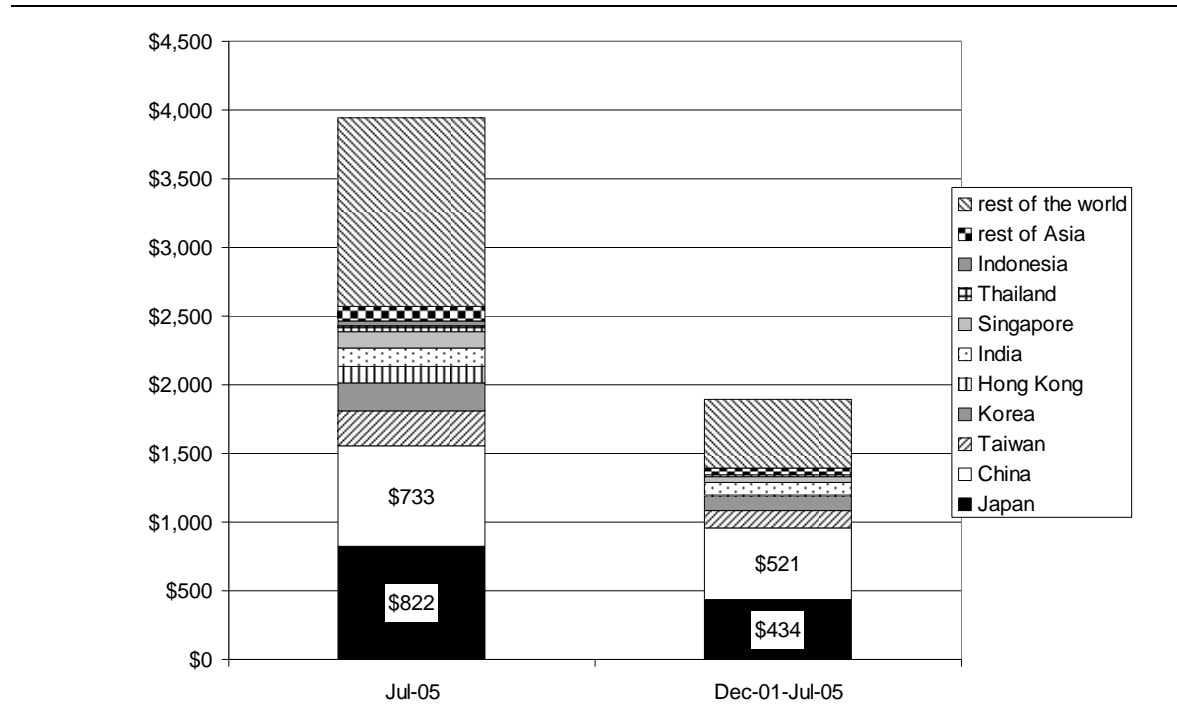
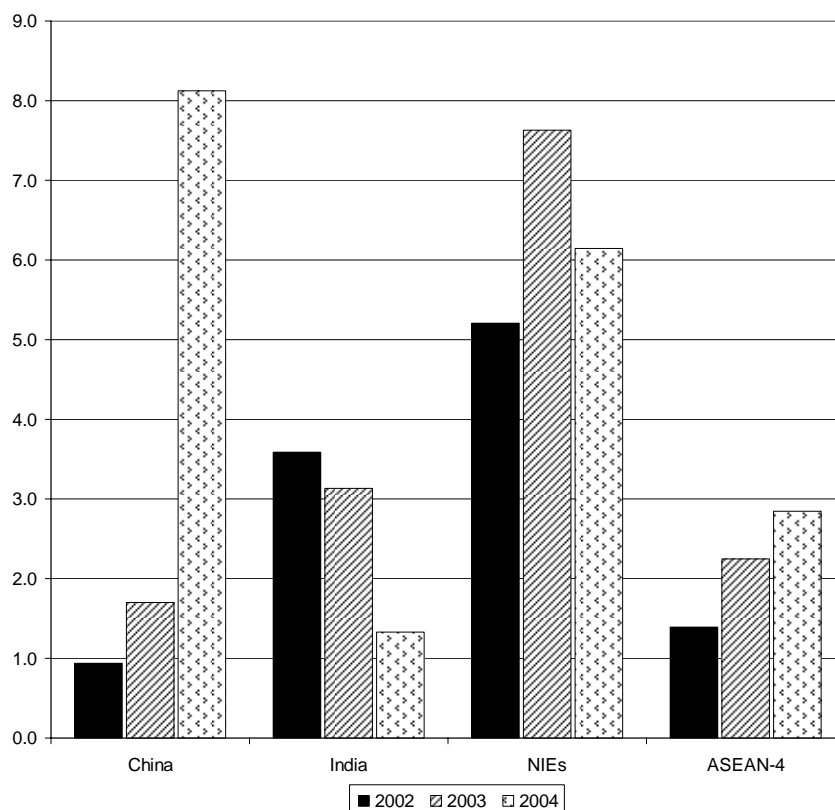


Figure 22 **Sterilisation (reserves growth, less growth of base money, as per cent of GDP)**



Data source: IMF.

The overall picture then is quite clear. The current global balance of payments is, indeed, a reflection of savings-investment balances, but these are not themselves something that has just happened. They are the byproduct of policy decisions taken by governments. This is particularly true of Asia, where deliberate attempts to preserve export competitiveness are supported by macroeconomic policies that succeed in sustaining the counterpart domestic savings surplus and so maintain internal balance, despite the high external surplus.

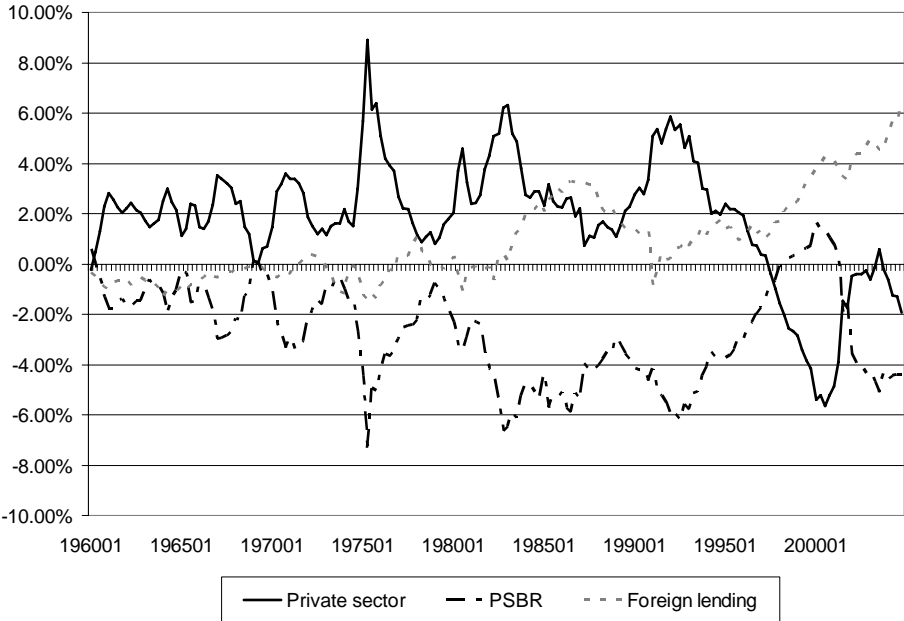
The US response

How is the United States responding to the behaviour of the rest of the world? The answer is that it is running demand policy that accommodates the world's excess savings and still sustains US output as close as possible to its potential. It is the country best able to fulfil this global 'adding up' function because it is able to issue the world's most desired monetary store of value.

That the United States is not an autonomous actor, but at the mercy of events in the rest of the world is difficult for many Americans to accept, but easy enough to see from an analysis of the financial balances — the relationship between income and spending — of the three principal sectors of an open economy: foreigners, the government and the private sector (figure 23). For most of US post-war history, the private sector ran a small financial surplus, the government ran deficits and the foreign sector was broadly in balance. There was a big current account deficit in the early 1980s, whose domestic counterpart was the fiscal deficit — the famous twin deficits. But that external deficit had disappeared by 1990. Since then, however, something quite unprecedented has happened.

The foreign sector went into ever larger surplus with the United States (ie the current account deficit increased steadily to reach 6 per cent of GDP), with most of this increase since 1997, the year of the Asian crisis.

Figure 23 Financial balances of the US economy (per cent of GDP)



Until 2000, the domestic counterpart of this rising foreign surplus was a move into deficit by the US private sector. During the bubble years, the private sector’s financial balance swung from a surplus of 6 per cent of GDP in 1992 to a deficit of 5 per cent. This huge and entirely unprecedented movement by the US private sector into deficit — in a period in which spending grew faster than income by 11 percentage points of GDP — allowed the government to go temporarily into surplus.

After the bubble burst, the private sector went back into balance (though not, as one would normally have expected, into surplus). But since foreigners kept on lending,

it was the government that ended up taking the strain. The shift of the government into deficit is a perfect mirror image of the shift of the private sector into balance.

Thus, the job of sustaining demand in the context of the huge drain on demand of the current account deficit shifted from the private sector to the government sector. If the US government had not gone so massively into deficit, what would have happened? Either a big recession, which would have reduced the current account deficit somewhat, or a still more aggressive monetary policy. Fed Funds might well have hit zero, as the Federal Reserve tried to sustain a huge private sector financial deficit in the post-bubble era.

The widely held view that the fiscal deficit is causing the current account deficit is, therefore, the wrong way round. It is much closer to the truth to say that the current account deficit is causing the fiscal deficit.

It is equally wrong to argue that the current account deficit is merely the consequence of relatively fast US growth. It is rather the consequence of relatively fast demand growth, in relation to supply, itself a function of the overall real exchange rate — or, to put the point in less technical terms — of US (un)competitiveness.

This story can be told in the following way: US demand has had to grow faster than potential GDP to accommodate foreign lending. Technically, at the real exchange rate of the dollar created by the policies of the rest of the world, US demand has had to grow faster than potential output, if actual output is to grow in line with potential output. And that is again precisely what has happened. From 1997 to 2003, inclusive, real demand grew faster than GDP in every year, except 2001, the year of the slowdown. Cumulatively, the difference was more than 4 per cent of GDP. The price that had to be paid was policies that promoted what may well prove to be a housing bubble, after the earlier stock market bubble.

Necessarily, these relationships between US aggregate demand and supply have precise counterparts in capital flows and trade. Here, however, two points need to be made.

The capital flows pouring into the United States were, until 2001, private. So those who argued that the deficits reflected the unparalleled attractions of the US private sector to profit-seekers around the globe were correct. But between 2002 and 2004, 43 per cent of the finance of the current account came from official sources. In round numbers the net official inflow over these years was \$718 billion. In absolute terms, this is the largest ‘foreign aid’ programme in world history.

This has also had huge effects on the structure of US output and trade. Imports are now about 60 per cent larger than exports (figure 24). This is the consequence of a long period in which imports grew at about 8.5 per cent a year in real terms, while exports grew about 5.5 per cent. The implication of this is straightforward: so long as GDP grows at about 3.5 per cent, exports must grow substantially faster than imports, merely to keep the trade deficit constant as a share of GDP. In fact, exports have to grow about 1.5 percentage points a year faster than imports to achieve this over the next ten years. That, evidently, would be a huge reversal of recent trends and requires a large change in competitiveness.

If the past 15 years' trends continue, with no adverse shift in the relative cost of funds to the United States, the ratio of net liabilities to GDP would reach 120 per cent by 2014 and the current account deficit would be 13 per cent of GDP. By then, the United States would be selling net liabilities each year equal to its annual exports (figure 25). Already its annual addition to net liabilities is 70 per cent of exports. Can anybody seriously imagine the country would ever repay?

Yet even if the current account deficit remained constant as a share of GDP, the net liability position would reach 70 per cent of GDP — a crisis level by historical standards and exceptionally high by the standards of other advanced countries. At that point US net liabilities would also be seven times annual exports. Think how vulnerable this must make the United States to changes in policies or attitudes elsewhere?

So far, however, the real exchange rate depreciation of the US dollar has been relatively modest. It remains well above its floor (figure 26). Yet most analyses suggest that very large real depreciations indeed would be required to achieve the necessary shifts in demand and supply of tradeables. Estimates vary. But an overall depreciation of 50 per cent from the peak would be quite plausible. That, in turn, would mean that the adjustment was only about a third of the way over. Furthermore, the longer the adjustment is postponed, the bigger it has to be, above all because the net income account will become ever more negative.⁵

⁵ See, among others, the following interesting analyses: Olivier Blanchard, Francesco Giavazzi and Filipa Sa, 'International Investors, the U.S. Current Account, and the Dollar', pp. 1–49, Maurice Obstfeld and Kenneth S. Rogoff, 'Global Current Account Imbalances and Exchange Rate Adjustments', pp. 67–146 and Sebastian Edwards, 'Is the U.S. Current Account Deficit Sustainable? If Not, How Costly is Adjustment Likely to Be?', pp. 211–72, in *Brookings Papers on Economic Activity*, 2005, 1.

Figure 24 Exports and imports as a share of GDP (current prices, per cent)

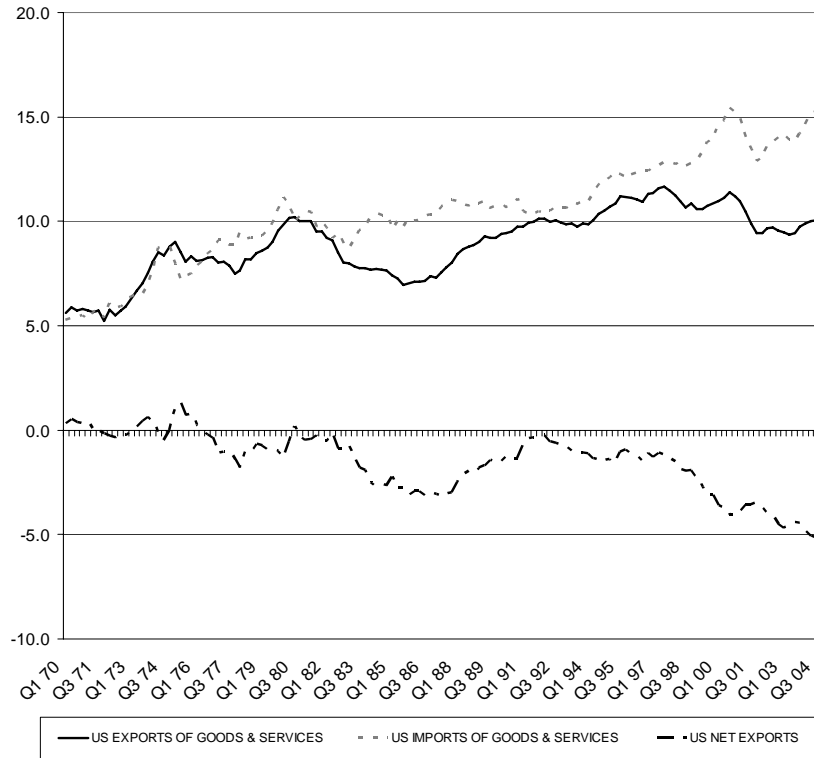


Figure 25 Alternative paths for US net liabilities (per cent of GDP)

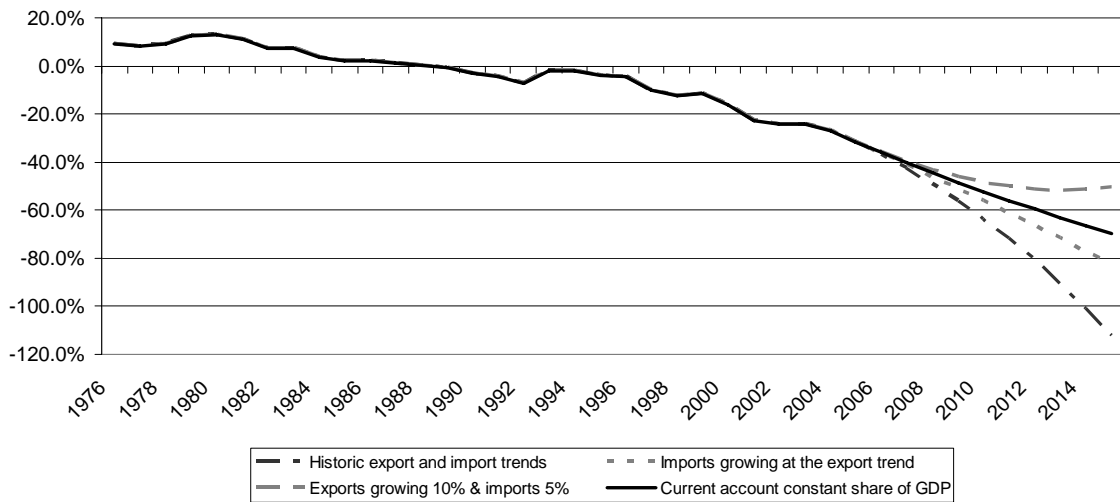
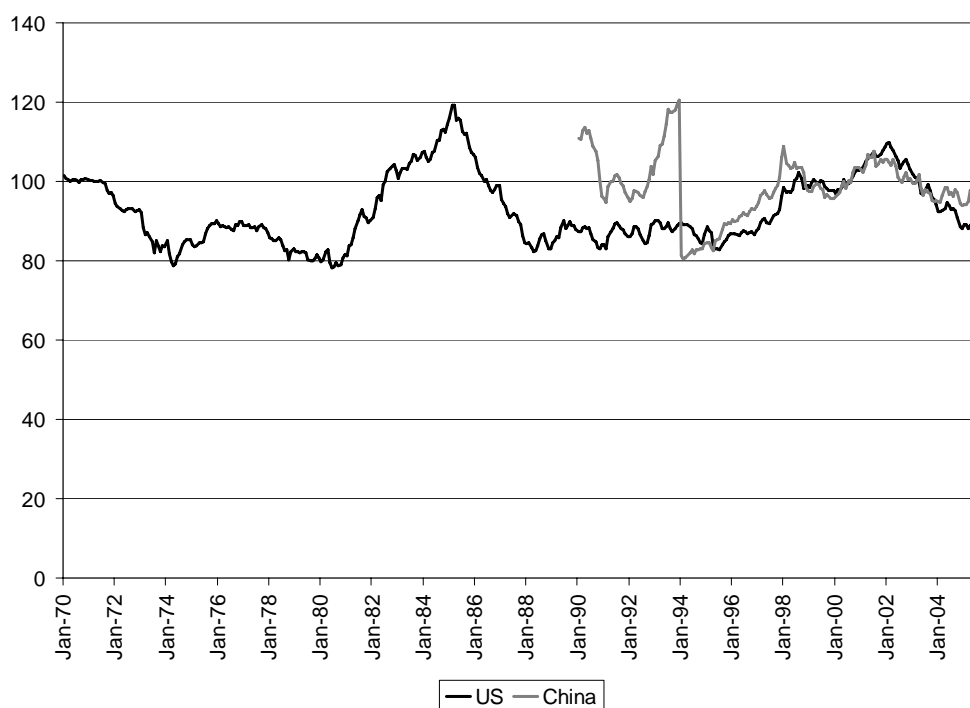


Figure 26 Real exchange rate for the USA and China (JP Morgan)



The end game

There are understandable reasons for the exchange rate and reserve accumulation policies of emerging Asia. These avoid any risk of further large-scale financial crises, they create a de facto monetary area, without explicit co-ordination, they sustain export competitiveness and so industrial growth and they reduce the need to confront the weaknesses of the domestic financial system. They even ‘pay’ for US-provided security.

But these policies are also problematic.

- It may prove quite hard to sterilise the monetary impact of such huge reserve accumulations in the long run.
- The real returns on the assets these countries own in the United States are low.
- They also risk very large capital losses when their currencies adjust upwards. China might lose 10 per cent of GDP, or even more.
- Subsidising exports through an undervalued exchange rate and unhedged lending in foreign currencies is very expensive. It is quite likely that these countries will end up with little more than half of the cost of those exports.

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- Most Asian countries have reserves close to or even greater than 100 per cent of annual imports. That is more than enough for any conceivable purpose. So the insurance they have bought has become excessively expensive.

Overall, it must make sense for the Asian emerging market economies to find an exit strategy. Accumulating reserves without limit cannot make sense. But they need help in finding that strategy, since there are big difficulties in developing and operating an alternative exchange rate arrangement, again particularly for China. It is important to understand those difficulties. An upward adjustment of the exchange rate may, unless it is very large, merely create more speculative pressure. A floating exchange rate, however, might create excessive uncertainty and, worse, be mismanaged by the inefficient Chinese banking system. These objections can be met, I believe. But it is easy to understand why the Chinese authorities are so cautious.

How does this look to the United States? The United States enjoys a huge transfer of resources — greater than the fiscal deficit or its entire military spending. This is guns and butter, quite unlike the Viet Nam era. George W. Bush has been a lucky man.

So what are the drawbacks of huge current account deficits (if any) for the United States?

- US industries producing tradeable goods and services are weakened and protectionist pressure risks increasing.
- If the fiscal deficit is to be reduced, the US private sector's financial deficit must be pushed upward again to very high levels. That would demand renewed monetary loosening and domestic debt expansion.
- If the foreign credit were to be cut off, the dollar would plunge, inflation and interest rates would rise and the economy would, almost certainly, go into recession.
- The creditors are, it should be recalled not necessarily friendly. Indeed the United States defines China as a strategic rival.
- Not least, the longer the delay the bigger the adjustment will become.

What should be done?

The process now under way is unsustainable. If it is not corrected in time, the United States could end up with a huge adjustment shock. The correction would involve a real exchange rate depreciation (which means a big one-off increase in the price level) and a recession, as interest rates spike upwards. Moreover, the bigger

the net liabilities and the larger the current account deficit at the time of correction, the larger the shock to the United States (and the world as a whole) is likely to be.

The United States cannot change its position without a prior change in the rest of the world. For this to happen only the Asians need to make a policy decision: that decision is to wean themselves from their mercantilist development model. The world's most dynamic economies need to be capital importers, not vast exporters. If they ran deficits equal to long-term capital inflow, the global balance of payments will be transformed. The start must be made by China, not only because it is so large, but because it is the leader of the region. The need for change is very large. Imagine that China continues on its present growth path, savings remain at 50 per cent of GDP and investment falls to a still extraordinary 40 per cent. Then China's current account surplus would be \$300 billion a year inside five years.

The open trading system Richard Snape loved would not survive this. This is not a question of economic logic, but of political reality. American politicians will react, probably brutally. Those who want the open economy to survive should argue strongly for a world in which open-ended US deficits are not the balancing wheel of the world economy. The wheel is going to come off.