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Key International Economic Issues of the Day: A Policy Economist's Perspective

Yusuke Horiguchi[†]

Abstract

The paper, drawing on a series of recent notes, discusses some of the most intensely debated policy issues in international economics, including: the recent financial market turmoil that started with the U.S. subprime loan crisis and the much discussed wealth effect (or lack thereof) of a house price change; global current account imbalances, with a focus on the underlying causes and the needed policy changes; and the role of the International Monetary Fund (IMF) in facilitating a successful resolution of the global imbalance problem. The paper concludes by emphasizing the critical operational role the IMF can play in offering a multilateral solution to current global challenges. The solution cannot be anything other than multilateral, and a multilateral solution cannot be achieved without the IMF effectively playing its mandated role, with full support of its shareholders.

JEL Classification: F01, F02, G15

Keywords: U.S. subprime loan crisis; IMF; global current account imbalances; IMF surveillance.

I. Introduction

This paper, drawing on a series of notes I have prepared for several recent occasions, discusses some of the most intensely debated policy issues in international economics. For convenience, I have organized the discussion in the following manner. Section I focuses on the recent financial market turmoil that started with the U.S. subprime loan crisis in the summer of 2007 and the much discussed wealth effect (or lack thereof) of a house price change. Section II brings us to the topic of global current account imbalances, highlighting in particular the underlying causes and the needed policy changes, including exchange rate adjustments. Section III follows up on Section II by discussing the role of the International Monetary Fund in facilitating a successful resolution of the global imbalance problem. Finally, section IV presents a few concluding remarks.

II. Current Events and Issues

The issues addressed in this section are among the most pressing of the day. The first note, prepared for a roundtable in Washington in October 2007, discusses key features of the current financial turmoil

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triggered by the U.S. subprime debacle and analyzes what went wrong. This is to set the stage for the financial industry's efforts, under the auspices of the Institute of International Finance (IIF), to refine market best practices with a view to avoiding a repeat of the kind of turmoil experienced over the past several months.

The second note was also prepared in October 2007. It deals with the question whether a change in house prices causes wealth effect on consumption. With the median house price in the United States declining for the first time in many decades, and this decline taking place in a situation where the U.S. economy is seen by many as on the brink of a recession, the potential wealth effect of house price changes is a huge issue. This note provides an analytical underpinning that is capable of an unambiguous, if unexpected, answer to this issue. Of course, as any other theoretical pursuit, the result of this analysis is a first approximation, and further inquiries are needed to deal with real world complications.

II – 1. Financial Market Turmoil: What Went Wrong?

I am sure you all are familiar with recent developments in global financial markets. Nonetheless, I thought it would still be useful to start my remarks with a brief re-count of what has happened to provide an appropriate background for the subsequent discussions on the lessons learned and a new IIF initiative. I will focus on just a few key developments that defined, so to speak, different chapters of recent market dynamics.

- The trigger was the sharp rise in subprime mortgage delinquencies in the early summer of 2007, which in turn led to a steep widening in credit spreads across all securitized pools of subprime mortgages. Rating agencies' multi-notch downgrades of a long list of subprime-linked structured products exacerbated price declines in part through engendering doubts about the validity of ratings on those complex structured products. In the meantime, the widely dispersed risks through the use of derivatives and structured products has made the assessment of where subprime-linked losses lie very difficult, leading to heightened sensitivity to counterparty risk.
- The sharply elevated uncertainty about valuation and creditworthiness of counterparties led to a plummeting of liquidity in subprime-linked segments of financial markets. Markets' attention then came to be focused on conduits and Special Investment Vehicles (SIVs), who fund the holding of structured products—including subprime-linked assets—with short-term asset-backed commercial paper. Investors in ABCP (mainly risk-averse money market funds) took immediate fright in favor of safer assets such as Treasury bills. Denied CP funding, conduits and SIVs, which are usually set up (as independent legal entities) and administered by banks, began to draw aggressively backstop bank lending lines.
- All of a sudden, many of the world's largest commercial banks found themselves scrambling for liquidity, caught with a surge in lending to conduits and SIVs whose asset quality and market values had come under deep suspicion, at a time when intense counterpart concern was developing among players in interbank markets. The balance sheet strains of a number of major banks related to LBO bridge loans have made matters worse. Subprime credit problems by then had turned themselves

into a systemic liquidity crisis. Unlike in many other parts of financial markets, the tensions in term money markets are still lingering even after sustained liquidity infusion by some of the leading central banks.

What went wrong—lessons to be learned

In discussing what may have gone wrong, my purpose is to facilitate the distillation of lessons to be learned, on the basis of which the IIF should launch an initiative toward the goal of a better functioning market. To that end, I will divide up the problems the markets have encountered into two groups:

- The **first** is a set of underlying problems that can be considered as pitfalls related to a business model of “originate and distribute” making use of innovative risk transfer mechanisms.
- The **second** relates to market and funding liquidity risks that have manifested themselves as part of market dynamics set off by the aforementioned underlying problems.

Let me emphasize here, lest a wrong impression should get created, that, a number of pitfalls notwithstanding, the business model of originate and distribute, if managed well, is certainly viable for individual financial firms and beneficial for the financial system. But to manage this business model better, its shortcomings need to be clearly identified using the experience gained during the current turmoil.

Pitfalls of credit risk transfer mechanisms and an “originate and distribute” business model

1. Lending standards have been lowered: loans with potentially very high default risks have been made while risks have been mispriced. Another risk management problem in the context of the originate and distribute business model has been an overestimation of the efficacy of risk transfer mechanisms to off-load risks, which has led to an unwarranted complacency with serious consequences.
2. Wide dispersion of credit risks has made the assessment of where risks and potential losses reside very difficult. This has led to heightened sensitivity to counterparty risk once strains began to emerge in financial markets.
3. Instruments used to effect credit risk transfer are often very complex, making it difficult to assess their risks and values. This has led to an over-reliance on credit ratings on the part of potential purchasers of those products, which has become a major problem once credit rating agencies’ performance came to be questioned.

Liquidity problems

Those basic pitfalls of using credit risk transfer mechanisms have led to liquidity problems through diverse channels:

1. A sharp spike in subprime mortgage delinquencies since July 2007 has eroded the value of subprime-linked structured products, making them harder to sell (market liquidity problem). More complex and riskier structured products, which are illiquid to begin with, lost much of any liquidity they ever had.
2. The combination of heightened uncertainty about values and valuation with heightened sensitivity

to counterparty risk has proved to be a powerful deterrent to trading, eroding further market liquidity of subprime-linked structured products.

3. The decline in the values of those structured products and the plunging in their market liquidity have combined to present major funding liquidity problems to many financial firms which hold substantial volumes of such products.
4. Conduits and SIVs, which banks have used as part of the originate and distribute business model to disperse risks (while also reducing funding costs), have been the entities most affected by the funding liquidity problem.
5. The funding liquidity problem of conduits and SIVs has posed major challenges to many of the largest global banks. Securing of interbank financing has been difficult in the face of heightened sensitivity to counterparty risks, even among major global banks.

New IIF initiative for a better functioning market¹

Let me conclude my statement by outlining the new IIF initiative toward the goal of a better functioning market. Representing the large part of global financial market participants, IIF members have a special responsibility to deal head on with the problems that have been brought home during the current turmoil. First and foremost, we have to find ways to minimize the risks stemming from the pitfalls somewhat inherent in the originate and distribute business model based on credit risk transfer mechanisms. In this connection:

- We all have to redouble efforts to improve risk management within the context of the originate and distribute business model which, as I stressed earlier, is certainly viable for individual firms and beneficial for the financial system provided it is managed well. The emphasis should be as much on the oversight and enforcement aspect of risk management as on the analytical dimension. Extreme risk positions should not be allowed to be taken again.
- Valuation of complex products in the absence of reference market prices is an awfully difficult issue, but we need some measure of standardization in terms of the way individual firms value their assets in such circumstances. How to achieve more credible ratings is part and parcel of the general issue of the assessment of risks and values.
- Key to reducing the sensitivity to counterparty risk are enhanced disclosure and transparency and also strengthened communication among market participants, especially in times of stress. Of course, the quality of what to be disclosed is of paramount importance, and that is why the IIF's new initiative will tackle forthrightly the issue of valuation, as was just noted.

By addressing those issues, we should be able to deal with much of the liquidity problems that I discussed earlier. In addition, however, it is important to address, as a separate liquidity issue, the maturity mismatch and rollover problems associated with operations of conduits and SIVs. Questions about asset quality of those entities exacerbated rollover difficulties and merit a thorough review as part of efforts to minimize the risk of the recurrence of the liquidity problem of the kind we have

¹ For those who are interested, the Interim Report of the IIF's Committee on Best Practices, which was made public at a press conference on 9 April 2008, is available at www.iif.com.

recently experienced.

II -2. House Price Increase: Wealth Effect on Consumption

A homeowner who actually resides in the house he/she owns, rather than owning the house for investment purpose, earns imputed rent on that house and pays the same amount for the use of the house. Homeowners who are non-economists usually are unaware of the income they earn from owning a house as well as the imputed rent they are paying. They are aware of the mortgage payment for the debt-financed portion of the house they reside in but unaware of the “cost” associated with the use of the equity portion of the house. This is an imputed cost, or opportunity cost. (By the way, the cost associated with the use of the debt-financed portion of their houses is not the same as mortgage payment, but that is an unnecessary detail as far as my discussion here goes.)

A more intuitive way to visualize this is to think of a situation in which you rent out a house you own to someone and at the same time you rent a house which is exactly the same in every aspect from someone else. You will receive rent from the tenant and you pay the same amount to the renter of the house in which you reside. You pocket the portion of the rent you receive that accrues to the equity portion while passing on the portion accruing to the debt-financed portion (if you have a mortgage outstanding). In economic terms, this situation is exactly the same as one owning a house and residing in it. So, I go back to the situation I was discussing above, in which homeowners reside in their houses.

When their house prices rise, their net worth rises. However, there will be no wealth effect on consumption (defined as excluding consumption of houses, or more precisely consumption of services rendered by houses that they own). This is because of the following reason. Homeowners will receive higher imputed rent as a result of the house price increase but they also pay higher imputed rent for the continued use of their houses which are now more expensive. There is nothing left for incremental consumption. The rent they pay is user cost of capital, which consists of interest payment (either actual or opportunity cost) plus depreciation minus any capital gains. The imputed rent they earn is exactly the same. (It's the good old Jorgenson stuff.)

If homeowners cash out some of the increase in house prices, the imputed rent they earn will be less (than the new higher amount) while the rent they pay remains unchanged (at the new higher level). The present value of the reduction in the imputed rent they receive is precisely the same as the amount they have cashed out.

While the amount cashed out will raise consumption in the immediate and following periods, the reduced imputed rent, in the face of the unchanged rent they pay for the continued use of their own houses, will reduce consumption (excluding consumption of houses) over a number of periods. The present value of the reduction in consumption over a period of time caused thus is precisely the same as the present value of the increase in consumption caused by the cashout, which should in turn be equal to the amount of cashout.

What happens as a result of cashout is merely an intertemporal reshuffling of consumption without any change in the present value of the stream of consumption (excluding consumption of houses). It is

not a wealth effect. A wealth effect of a (permanent) rise in house price, housing wealth, and net worth of homeowners should involve a rise in the present value of the stream of consumption.

To verify the validity of this argument, all that one has to do is to consider what will happen to consumption if homeowners cash out the same amount but in the situation of no house price increase. The stream of consumption will be exactly the same as in the case discussed above where homeowners cash out in the wake of an increase in house prices. Its present value is no less or no more. The increase in house prices and housing wealth are immaterial in this context.

All told, there is no such thing as a wealth effect on consumption (excluding consumption of houses) resulting from house price increase. All that happens as “wealth effect” is an increase in consumption of houses which is equal to the increase in imputed rent paid occasioned by the rise in house prices. By the way, the present value of the increase in the stream of imputed rent received and that of the increase in rent payment are, both, exactly the same as the rise in house prices.

To conclude this note, let me discuss a case of a typical young American who climbs up a “house ladder” by taking advantage of the trend-like increase in real house prices and opportunities for financial leverage.

- Suppose that this young man (or woman) initially owns a house whose market price is \$100, with a mortgage of \$50, and that the user cost coefficient is 0.1 (that is, the imputed rent, on both receipt and payment sides, is 10% of the \$100 house price). He then receives an imputed rent of \$5 (after netting out the \$5 that accrues to the debt-financed portion of the house) and pays an imputed rent of \$10, with the negative gap of \$5 to be financed by the rest of his income. Note that the part of the imputed rent receipt that accrues to the debt-financed portion of the house is not just interest on mortgage debt but includes also depreciation/maintenance, offset by any capital gains.
- Suppose that the house price doubles to \$200, with all other things unchanged including his real income. He then receives \$15 in imputed rent and makes a \$20 imputed rent payment, with the \$5 gap financed by the rest of his income. His consumption (excluding consumption of housing services) thus remains unchanged.
- Suppose he then buys a bigger house of \$300 by selling his initial house, borrowing another \$100 to keep unchanged the debt-equity ratio of his house financing. He then receives an imputed rent of \$15 (just as before the purchase of the new house) and makes an imputed rent payment of \$30, with the gap now of \$15 financed by the rest of his income.
- Obviously, his consumption (excluding consumption of the house) will be less than if he had held onto his initial house whose price is now \$200. This is because he decided to increase his consumption of housing services by \$20 (from \$10 to \$30) by buying the new and more expensive house, rather than by \$10 (from \$10 to \$20) by holding onto his initial house, when his imputed rent receipt rose by \$10 as a result of the doubling of the price of his initial house which raised his net worth by \$100.

This example illustrates that the effect on consumption (excluding consumption of house services) of an increase in housing wealth occasioned by a rise in house prices in this rather typical situation is negative! (Of course, this is different than saying that the total wealth effect is negative because

consumption of housing services has increased. But the wealth effect refers normally to an increase or decrease in consumption excluding that of services rendered by the house.)

III. Global Current Account Imbalances

The following two notes are both dedicated to issues relating to the global current account imbalances, which have been in the forefront of international policy debate over the past several years. This debate has grown in its intensity more recently as the persistent downtrend of the dollar is seen by some as the precursor of the day of reckoning, when the unsustainable imbalances will finally give rise to disorderly dollar depreciation with adverse ramifications for many corners of the global economy.

The first note, presented at an American Enterprise Institute (AEI) seminar in July 2003, might look dated at first sight. However, it deals with the issue which has restored its prominence nowadays with the euro appreciating against the US dollar visibly while the Chinese renminbi (RMB) is rising vis-à-vis the dollar at a snail's pace. The issue in a nutshell is whether the nonappreciation of the RMB places an extra burden of international adjustment on the Eurozone in the form of the euro's disproportionate appreciation. Once again, the answer given in this piece is somewhat surprising.

The second note, presented at an AEI conference in November 2004, deals with the basic causes of imbalances and prescribes a coordinated strategy that should be pursued by relevant parties, including the United States, the Eurozone, Japan, and China. It emphasizes that the common goal should be to make major inroads into the global current account imbalances while keeping global growth at a satisfactory pace. In other words, the restoration of a better global current account balance through, for example, a prolonged U.S. recession is not what should be pursued.

III-1. The Dollar and Asia

In the old days of the Bretton Woods system of fixed exchange rates, defining a needed external adjustment was a straightforward matter. Under that system, when the currency of a country came under downward pressure, reflecting a weakening of the overall balance of payments, reserve losses ensued, putting the currency peg at risk. Then the country in question had to adjust in order to strengthen overall balance of payments sufficiently to protect the peg through policy changes, typically in the form of a contractionary fiscal policy and a tighter domestic credit policy.

From time to time, the issue regarding the responsibility of surplus countries arose; namely, should they help the deficit country through a stimulative fiscal policy and a loosening of domestic credit policy? The basic issue, however, was the adjustment of policies by the deficit country aimed, inter alia, at compressing domestic absorption to bring it into line with domestic income to stop market forces from putting further pressures on the exchange rate and reserves. This compression of domestic absorption (and its possible negative effect on GDP) was the burden of adjustment.

In the present day world of floating exchange rates among most currencies, it is more difficult to define what the needed external adjustment is all about. That, however, never stops economists

arguing about it. For example, in recent days, we hear many economists and commentators talking about “the needed global adjustment,” citing the outsized U.S. current account deficit and an overvaluation of the U.S. dollar. To sharpen the debate, I feel it would be useful to define more precisely what a needed external adjustment in a floating world is all about.

One way to go about defining it is in terms of financing constraints on current account deficit imposed by private capital markets. In such a definition, external adjustment is an autonomous process (not induced by policies) through which an unsustainably large current account deficit is reduced to a sustainable size under the influence of a market-driven weakening of the currency, which depreciates to a level consistent with the sustainable current account deficit.

I believe this is along the lines of what people seem to have in mind when they now talk about the needed global adjustment. Let me emphasize that external adjustment in this definition is a market-driven phenomenon whereas, under the Bretton Woods system, external adjustment was all about policy actions needed to counter market forces that were threatening the survival of the peg.

It should be noted that this definition of the needed external adjustment does not imply that external adjustment should/could take place only as a result of exchange rate changes. The needed external adjustment, the size of which can be measured notionally by how much the exchange rate of the deficit country has to depreciate to bring about a sustainable current account deficit, can be achieved by a combination of exchange rate changes and macroeconomic policy actions. The specific definition used here based on the exchange rate is for the sake of adopting an unambiguous metric of the size of a rather vague concept in the world of floating exchange rates.

Having defined what the needed external adjustment means in the world of floating exchange rates, I would like now to discuss, in a loosely theoretical way, whether Asian countries’ attempt to limit appreciation of their currencies against the dollar increases the burden of global adjustment to be shouldered by the Eurozone. This is the most prominent aspect of the current debate on global adjustment.

Now let me describe my simple model. Suppose that the world consists of three large countries/regions, namely, the U.S., the Eurozone, and Asia, each with a single currency. Let’s assume (i) that they are of about equal size; (ii) that each of them exports to and imports from the two others in an equal proportion; and (iii) that their assets are close substitutes but not perfect substitutes and the degree of substitutability between any pair is the same as others (for example, Asian assets and Eurozone assets are as close substitutes as, say, Eurozone assets and U.S. assets are).

Now, suppose for argument’s sake, (i) that the U.S. dollar is judged by the markets to be overvalued by 30 percent vis-à-vis each of the two other currencies, and (ii) that the market-driven adjustment, under the prevailing conditions, is to entail a 30 percent depreciation of the dollar vis-à-vis each of the two other currencies.

On this basis, let me go through two mental experiments. Let’s start with the first one. Assume that the authorities of both the Eurozone and Asia did nothing else but to allow market forces to push the dollar down by 30 percent against each of the two currencies. The euro then would appreciate by 15 percent in effective terms as it appreciates 30 percent against the dollar and stays put relative to the

Asian currency. The currency of Asia, likewise, appreciates by 15 percent in effective terms.

To maintain the same level of economic activity as that prevailing prior to the appreciation, those two regions would have to do something to strengthen domestic demand. Otherwise, their GDP would weaken as a result of the appreciation. This is the burden of adjustment for these two.

Now, the second mental experiment. Assume that the authorities of the Eurozone again do nothing else but to allow market forces to do their work. Assume, however, that the authorities of Asia carry out as much sterilized intervention as necessary to keep its currency from appreciating against the U.S. dollar. In this case, given the technical assumptions I made earlier regarding the size of the countries, trade flows, and the degree of substitutability of assets, the dollar and the currency of Asia each would depreciate against the euro by 15 percent.

In effective terms, the euro then would appreciate by 15 percent, just as in the first case in which Asia did allow market forces alone to determine the fate of its currency and that of the dollar². Thus, the Eurozone in this second case would be bearing exactly the same adjustment burden as in the first case.

This to me is an interesting result, and contains many implications. For our purpose here, I would like to limit myself to one particular point: that is, that this result casts doubt on the widely held view that Asian countries' "misguided policy" of not letting their currencies appreciate against the dollar is hurting the Eurozone countries, by making them bear a disproportionate burden of global adjustment. My analysis indicates that, whatever the Asian countries may or may not do, the Eurozone faces the same burden of adjustment, i.e., a 15 percent effective appreciation with consequences for its current account, net exports, and growth.

Stated differently, my analysis indicates that Asia's current policy does not constitute a beggar-neighbor policy vis-à-vis the Eurozone countries. Given this conclusion, I would emphasize that, instead of worrying about how the Asian countries are messing up the adjustment process, the Eurozone countries should get on with the real job of strengthening domestic demand and implementing structural reforms.

Let me emphasize that I did not go through all this discussion in order to defend what the Asian countries are doing. I have not thought through carefully enough on an individual country basis, which any serious economist should do, all aspects of the issue of whether or not what they are doing now is defensible, for their own sake and for the sake of the world economy. Rather, I am simply pointing out the shaky validity of what by now has become the mainstream view on the issue of the effect of Asia's policy on the Eurozone countries.

Should we not be concerned about Asian countries' current policy? To me, Asian countries' intervention is disturbing not so much because this causes an added burden to the Eurozone, or even to the United States, but because it reflects their deeply rooted merchantilistic instinct with an almost

² Although I do not want to be very precise about this, the reasons for the euro's appreciating by 15 percent in effective terms in this case, as in the first case, is that the combined sum of the U.S. assets and Asian assets supplied in the market in the second case is exactly the same as in the first case. For the effective value of the euro, only the combined sum matters, and not its composition, given the assumptions made in this analysis.

religious attachment to trade and current account surpluses.

Over time, this instinct has to be brought under better control if Asia is to become a true frontrunner of global growth and development. They should grow confident enough to accept that, unless their trading partners are allowed to grow fast with strongly expanding exports, including to Asian countries, eventually Asian countries themselves would find no countries in which to expand their exports. International trade has to be for mutual benefits.

III –2. U.S. Current Account Deficit and the Dollar

The basic causes of the global current account imbalances are twofold: *first*, the persistent growth gap, particularly in domestic demand, between the U.S. on the one hand and the Eurozone and Japan on the other (Figure 1); *second*, the reluctance of Asian emerging market countries to let their currencies appreciate for fear of losing export markets. They have accumulated massive reserves by intervening heavily in the foreign exchange market (Figure 2).

Let me dwell a little on the first cause. As long as domestic demand growth in the U.S. is faster than the Eurozone and Japan, there is a tendency for the current account deficit of the U.S. to grow. It is easy to show *that, just to stay at the current level of 5½ percent of GDP, there is a need for the dollar*

Figure 1. Domestic Demand Index (1991=100)

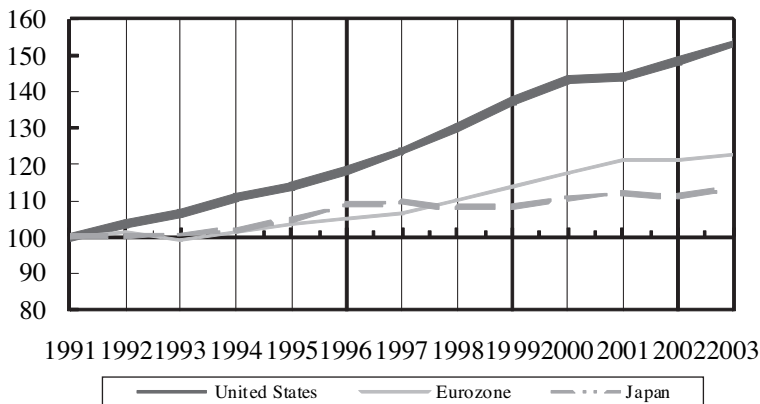
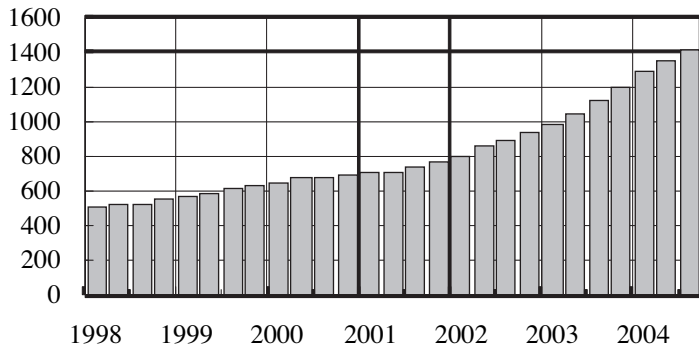


Figure 2. International Reserves in Emerging Asia (in billions of US dollars)



to depreciate in real effective terms.

Based on some arithmetic, I now want to show you that the greater the existing gap between exports and imports, the more difficult it is to shrink the gap. In nominal terms, the condition for narrowing the gap is given by:

$$x/m > M_0/X_0$$

The bigger the ratio of M_0 to X_0 , the faster exports have to grow relative to imports. For example, given (M_0 / X_0) of 1.5 now, x has to be more than 1.5 times faster than m . (The experience of last 5 years is x in the range of 10–12% and m in the range of 15–17%.)

As a ratio to GDP, the condition for narrowing the gap is given by:

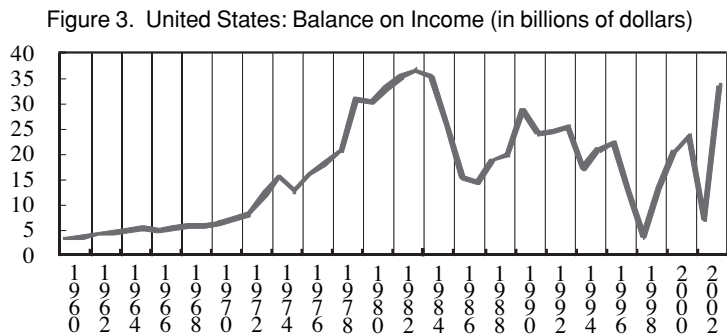
$$(x - g)/(m - g) > M_0/X_0$$

This formula makes it look as if the faster the growth rate of GDP, the easier it is to achieve this condition. Well, it is not necessarily true. Given the reality of $(\partial m / \partial g) > 1$, a faster GDP growth actually makes it more difficult for this condition to be satisfied.

A couple of conclusions can be stated at this stage.

- Even though all agree that a 5½ percent GDP current account deficit is not sustainable, it is difficult to envisage an actual narrowing of the deficit any time soon for the reasons I listed above, even with some further depreciation of the dollar.
- If one were to rely on the currency adjustment alone in bringing the U.S. current account deficit down to 2–3 percent of GDP (a plausible notion of a sustainable current account deficit), it would take much more than a 30 percent depreciation of the real effective exchange rate (REER) that many people talk about, with the main reason for that being demand growth differentials in the U.S.’s favor.

As another possible reason why the current account deficit could stay at the present level for some time, I want to show that, despite the unprecedentedly large current deficits, and a growing net liability position, the U.S. still tends to record a surplus in the investment income and payment account of the balance of payments (Figure 3). This casts some doubt on any need for a quick adjustment of the current account deficit toward 2 or 3 percent of GDP.



In addition, as is well known, a depreciation of the dollar affects the U.S. current account only with long lags. There are thus a number of reasons to think that the deficit of the current size could persist for some time. At the same time, it takes a lot of imagination to convince myself that the current account deficit of this size can persist for a very long time.

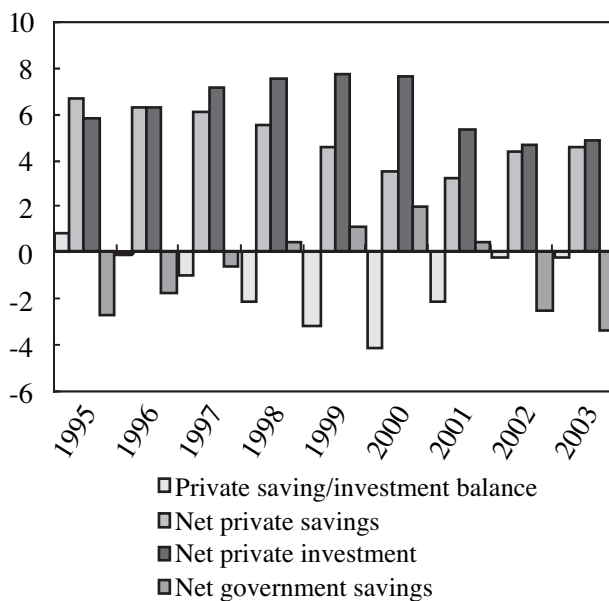
It is particularly so (i) in light of a less favorable configuration of the domestic saving/investment counterpart to the current account deficit that now exists than in earlier times and (ii) given the unfavorable shift in the pattern of the financing of the current account deficit in the past few years.

- On the first point, the bulk of the current account deficit is now “accounted for,” in terms of a domestic counterpart, by growing public sector deficit (Figure 4). In addition, the decline in the private saving–investment gap in the past few years reflected a sharp decline in the investment–GDP ratio, which has more than offset a significant decline in the savings ratio.
- On the second point, a growing portion of the U.S. current account deficit is financed by dollar purchases by central banks abroad; and out of the declining private flows, more and more are accounted for by debt flows rather than foreign direct investment (FDI) flows (Figure 5).

In a sense, U.S. external adjustment has already begun against these backdrops, in the form of the weakening of the dollar since early 2002, although it has not been large enough even to keep the current account deficit from widening further, let alone narrowing it.

Unfortunately, the adjustment process to date has not been an appropriate one, particularly because (i) it has been based solely on exchange rate changes; and (ii) the exchange rate changes that have taken place have been confined to too narrow a group of countries to allow a large decline in the REER of the dollar. Figure 6 shows that, while the dollar has depreciated by some 25 percent vis-à-vis G-10 currencies since early 2002, it has not weakened at all against the currencies of emerging

Figure 4. United States: Savings, Investment, and S-I Balance (in percent of GDP)



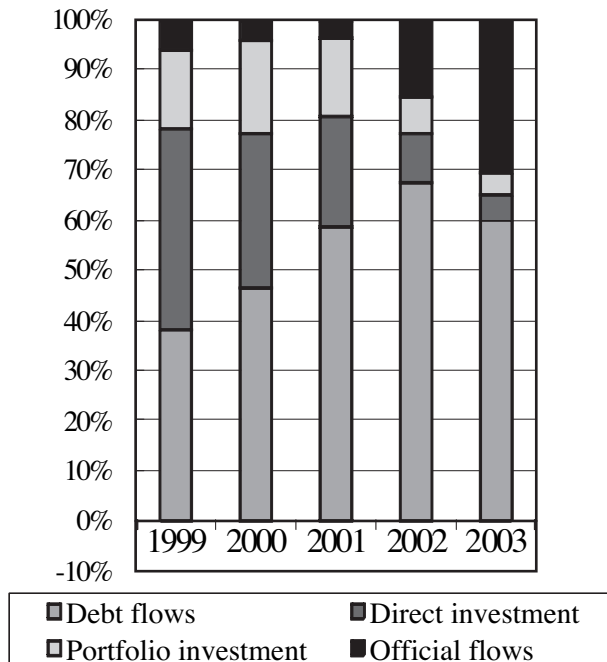
markets economies (EMEs).

What, then, is a sensible adjustment process? A sensible adjustment process should involve the following three elements as its key ingredients.

- First, a strengthening of economic activity in the Eurozone and Japan. These countries should first eliminate a huge output gap. This is an area where macro policies can make a real difference. Structural measures that would make macro policies more effective would help. Given the fragile state of their economies, I don't see much merit in a further strengthening of their currencies in real effective terms. I am afraid that these economies would be really badly hurt if their currencies strengthen much further in real effective terms. Even if the euro and yen are to strengthen further against the dollar, I would like to see this to be offset by a bigger appreciation of Asian EMEs' currencies against the dollar.
- Second, in addition to ensuring continued strength of their domestic demand growth, Asian EMEs should allow a meaningful appreciation of their currencies in real effective terms by stopping or moderating their foreign exchange market intervention.
- Third, the U.S. should strengthen its fiscal position as a main instrument for current account adjustment.

It is difficult to answer the question how much should the dollar depreciate in real effective terms to bring about the needed current account adjustment, because the answer depends on what other things are done and by how much. The kind of an adjustment strategy I have just outlined, if carried out seriously, would minimize the reliance on exchange rate changes as an instrument for global external

Figure 5. U.S. Composition of Capital Inflows



adjustment.

The real question, however, is the likelihood for such an enlightened strategy to be followed in reality. I must say I have serious doubts for the following reasons:

- First, it is difficult to see the Eurozone and Japan succeed in closing the existing huge output gap any time soon, let alone raising the trend growth rate. The only hope I have is that they will start moving in the right direction, and persist with it.
- Second, I don't believe, until I see it, that Asian EMEs will allow their currencies to adjust in a meaningful way any time soon. In their present value calculation, higher exports, economic activity, and employment they can now enjoy based on undervalued currencies is much more important than the capital losses on their reserve holdings resulting from any depreciation of the dollar that may happen sometime in the future. Some of them might even be betting on the continued tendency of the dollar toward mean reversion in the long term, as evident in Figure 7. This would mean no

Figure 6. United States: The Dollar's Real Effective Exchange Rates

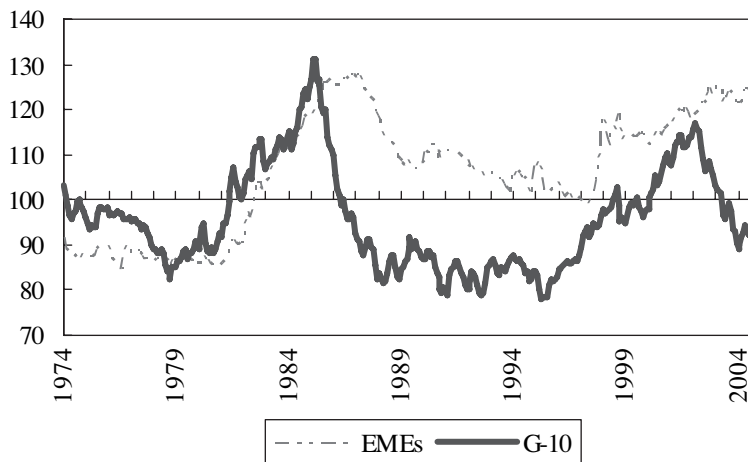
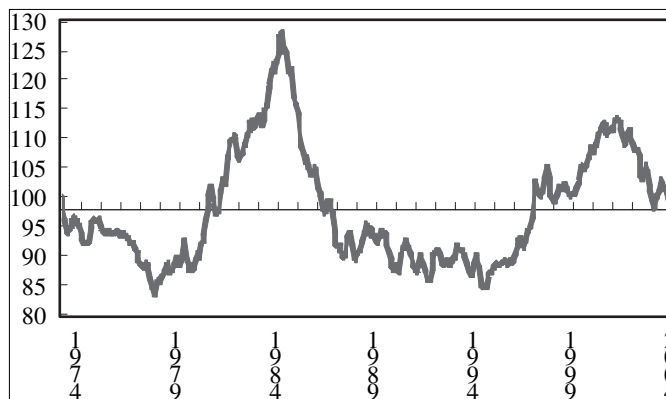


Figure 7. United States: The Dollar's Real Effective Exchange Rate (Broad Index; 30-year average=100)



capital loss!!

- Third, U.S. fiscal adjustment might prove elusive.

If my pessimism is not badly misplaced, and if the largest sustainable U.S. current account deficit is of the order of magnitude of 2–3 percent of GDP, as many people argue, then the U.S. current account would be adjusted eventually by the brute force of the market, which would manifest itself in a plummeting of the dollar, particularly vis-à-vis the euro and yen.

I myself do not think such a plunge of the dollar is a big problem for the U.S. But it's a huge blow to the Eurozone and Japan. The global growth, I believe, will be hurt. Even Asian EMEs, who would be ready to take steps to keep their currencies competitive, cannot remain immune for a long time from the weaker global growth.

I am sure policy makers in the U.S., Japan, the Eurozone, and Asian EMEs are all aware of the cost to their countries and to the global economy of such a scenario. Hopefully, the enlightened self-interest of those countries pushes their policy makers toward an adjustment strategy of the kind I outlined above, before a plunge of the dollar actually happens.

IV. Global Imbalances and the Role of the IMF

This section follows up on the previous section to discuss the role of the International Monetary Fund (IMF or the Fund) in the resolution of global current account imbalances. The first note was prepared for an AEI seminar in February 2006. It addresses the question of the role the IMF can usefully play as a central element of international efforts to reduce the global current account imbalances. The point of departure of my thought presented in this piece is that, while there is a good deal of consensus about what individual major economies ought to do in order to contribute to ameliorating the imbalances, no one wishes to take the lead unilaterally. The real issue, thus, is an operational one of how to encourage the concerned parties to start acting in a coordinated fashion. The note, in that context, proposes a scheme called Fund Simultaneous Special Consultations. There are indications that this proposal led later to the spring 2006 decision of the International Monetary and Financial Committee (IMFC) to authorize the Fund to undertake what is called “Multilateral Consultations.”

The second note, presented at an AEI seminar in February 2007, addresses the issue of the efficacy of U.S. bilateral “pressure” on China to accelerate the pace of RMB appreciation. My view, as presented in this piece, is loud and clear—It Does Not Work! After analyzing why it does not work, the note calls, once again, on the Fund to take the central role, not to push China alone but to encourage all concerned parties to play their part to achieve the goal of reducing the global current account imbalances while sustaining strong global growth.

IV–1. IMF Surveillance of Exchange Rate Policies: Simultaneous Special Consultations to Address Global Imbalances

Everyone agrees that the IMF is the anchor of the international monetary/financial system and the

guardian of the stability of that system, which is essential for sustained growth of the world economy. In my view, this pretty well summarizes in everyday language the basic purposes of the IMF, which are spelled out in detail in formal, legal language in Article I of the IMF Articles of Agreement.

Many of the remaining 30 Articles of Agreement are devoted to stipulating obligations of members and responsibilities of the Fund, fulfillment of both of which is essential for the achievement of the Fund's purposes. Among those, Article IV is the most relevant for the purpose of our discussion.

Article IV sets out obligations of members and responsibilities of the Fund in regard to exchange arrangements. Let me summarize what that article says, in a way that conveys as clearly as possible the spirit of it. Section I of that article calls on member countries to undertake to collaborate with the Fund to assure orderly exchange arrangements and to promote a stable system of exchange rates.

In particular, each member is called on (i) to endeavor to direct its economic and financial policies, including exchange rate policy, toward the objective of fostering orderly underlying conditions necessary for sustained growth with reasonable price stability and viable balance of payments and (ii) to avoid manipulating exchange rates with the aim of preventing effective balance of payments adjustment or gaining unfair competitive advantage over other members.

Section 3 of the same article calls on the Fund to oversee the international monetary system in order to ensure its effective functioning, and in that context calls on the Fund to exercise firm surveillance over the exchange rate policies of members.

I should add here that one of the enabling Executive Board decisions in relation to this article notes that the surveillance of the exchange rate policies should be exercised within a framework of a comprehensive assessment of the general economic situation and economic policy strategy of the member.

From all these, it is absolutely clear that firm surveillance of the exchange rate policies, as a central element of surveillance of members' economic policies more generally, is one of the fundamental mandates of the Fund. It's not an option for the Fund—it's a principal mandate of the Fund.

The Fund's Articles of Agreement is not the easiest document to read and understand. Accordingly, for the purpose of describing in the simplest language what the IMF is supposed to do—cutting through all these Articles of Agreement written in legal language—Stanley Fischer, a former First Deputy Managing Director of the IMF, once said that the Fund's responsibility is to be the center of excellence for macroeconomic policies, including exchange rate policies and also macro-relevant structural/institutional reform policies.

Given all this, and given the fact that I spent 24 years in the Fund trying day in and day out to contribute to the Fund discharging this macroeconomic surveillance responsibility, you can understand, I am sure, that I am not in favor of an individual IMF member exercising firm surveillance over another member's macroeconomic policies including exchange rate policy. It is much better for all concerned that the Fund exercise firm surveillance rather than any individual member or a group of members.

Of course, I know that the U.S. Treasury has no option but to do it, given its mandate under the Trade Act of 1988. I sympathize with my friends at the Treasury who, under the law, have to do what

can be seen as analogous to taking justice into one's own hands.

So, surveillance is the Fund's responsibility. No question about it. The real issue is how best to do it.

In order to be concrete and specific, I will base my following discussion on the most pressing systemic issue of today, namely, how best to address the huge global current account imbalances.

Let me start by saying that the Fund has done an excellent job in identifying the basic causes of the global current account imbalances and in coming up with a sensible set of policy recommendations pertaining to the United States, Eurozone, Japan and China, emphasizing the importance of concerted action by each and every one of these economies—not just China—for the common goal of orderly global adjustment.

The excellent job the Fund has done in analyzing the problem, however, is not enough. I would like to see the Fund go a step further—namely to make full use of all its operational capabilities and achieve the desired result of making each and every one of these economies actually take the needed policy action, for the purpose of collectively resolving the problem of the global current account imbalances.

Some may say that I am talking about a pie in the sky and that the Fund does not have sufficient instruments to achieve such a goal.

I say the Fund does indeed have a potentially workable instrument for this kind of purpose. It is called a special consultation, a tool to complement a regular Article IV consultation. By the way, it was reported in the *Financial Times* during the World Economic Forum meeting of January 2006 that Tim³ considered a special consultation to be akin to a nuclear bomb, or something to that effect. Coming from the only country which actually tasted it, I have to respectfully disagree. Or at least I would say this instrument can be used in a non-nuclear way. How can that be done?

Let me first say in this connection that Tim must have had in his mind a special consultation vis-à-vis China, and China alone. His analogy then would perhaps be on the mark. Be that as it may, China in any event would see such a special consultation as the U.S. exercising firm surveillance over another member simply through the veil of the IMF.

Let me now tell you my idea, which has nothing to do with a weapon of mass destruction of any kind, but has to do with a weapon for concerted adjustment efforts.

To get each and every one of those economies I mentioned earlier to carry out the actions each needs to take, the Fund, under my scheme, would dispatch a special consultation mission to each and every one of those economies simultaneously. The findings of those missions then should be spelled out in staff reports, which should be discussed by the Executive Board all at the same time, with the aim that the Board at the end of its deliberation agrees on a comprehensive action program specifying a set of measures to be taken by each economy with a specific timeline attached to each and every measure.

The final step is for the IMFC to put its seal of approval to the comprehensive action program,

³ Timothy Adams, who at that time, was the U.S. Treasury Undersecretary for International Monetary Affairs, was another speaker in the seminar.

announce it publicly, and mandate Fund management and staff to be a scorekeeper, who in turn should keep the Executive Board duly informed at all times.

The scorekeeper then will prepare a scorecard on a quarterly basis spelling out what each economy has done and has not done relative to the action program.

For those economies, which are judged not performing, another special consultation would be in order, perhaps in the form of the Managing Director's direct discussion with the economic authorities of those failing countries.

For transparency, the Fund should make the scorecard public. This would give a pretty good incentive for everyone to behave. A well-performing country would be seen as an honor student abiding by a collective international agreement for a common cause, instead of being seen as a wimp who was forced by a big country to do something they don't like. This of course is the vital difference between firm surveillance exercised by a multilateral institution such as the Fund and that exercised by an individual country.

Let me close by saying that, to enhance the likelihood of success, the Fund ought to refrain from coming up with an overly ambitious action program for those economies. Serious as it is, what the problem of the global current account imbalances requires is a credible first step of concerted action program at this time and perseverance on everyone's part with efforts to sustain the momentum of adjustment through steady implementation of further actions, rather than a program aimed at a totally unrealistic goal of quick resolution.

IV-2. China's Exchange Rate Policy: U.S. Pressure Won't Work

In this note, I plan to focus on the question of what policy options are available to the United States to encourage China to adopt a more flexible exchange rate policy and to reduce its reliance on the export sector as the primary engine for economic growth.

My first key observation is that no direct attempts by the U.S. based on bilateral contacts/discussions/negotiations would work.

- Those would fall on deaf ears or so it will seem. This is because the Chinese authorities cannot afford to be seen as succumbing to U.S. pressures, regardless of how gently the U.S. might intend to talk to them.
- Worse still, direct bilateral attempts could perhaps backfire. Backfire, particularly in the sense that more indirect efforts which could potentially be useful/effective would be made ineffective by persistent direct, bilateral attempts. This is because the Chinese authorities would fear that people would see indirect efforts simply as U.S. direct pressures in disguise.

Let me reiterate that the U.S. should not try to make direct attempts at changing China's policies using the bilateral channel. Better options are more indirect approaches whose usefulness, however, may be on the verge of being compromised by the direct approaches the U.S. has long followed.

Among indirect approaches, the one I see as potentially capable of helping the U.S. to achieve the goal of persuading and helping China to adopt a more flexible exchange rate policy and rebalance its economy is to work on this issue through the IMF, the multilateral institution mandated to exercise

firm surveillance over its members' exchange rate policy and associated macroeconomic policies.

How should the U.S. work indirectly via the IMF for this purpose? In this connection, let me first point out that to persuade and help China to adopt a more flexible exchange rate policy and rebalance its economy is an important goal for the health of the global economy, which is now carrying heavy baggage of very large current account imbalances as its key point of vulnerability. This whole issue, accordingly, should not be approached by the IMF as a China issue in isolation, or a bilateral issue between China and the U.S. This goal relating to China's exchange rate and other policies should be pursued as an integral part of a broader goal of correcting the global current account imbalances.

Let me note in this context that, in another AEI seminar organized by Desmond Lachman in February 2006, I called on the IMF to pursue this broad objective of helping resolve the huge global current account imbalances, while keeping healthy world growth going, based on the "instrument" that might be called multilateral or simultaneous special consultations. I believe this is similar, in its spirit, to a process which the Fund now calls multilateral consultations, a new Fund instrument that was endorsed by the IMFC at its spring 2006 meeting.

This process is what the U.S. should support with its full political might if the U.S., and more broadly the international community, are to succeed in addressing appropriately the global current account imbalances and, as part of that success, to achieve the goal of persuading and helping China to adopt a more flexible exchange rate and to reduce its reliance on net exports as the primary engine for growth.

In order for this new process of the IMF's multilateral consultations to succeed, the U.S. and China as well as other countries involved have to implement fully its share of a coordinated policy program aimed at tackling the global current account imbalances⁴.

Let me tell you bluntly in this context that the U.S. should forget about its goal of persuading and helping China to adopt a flexible exchange rate policy and rebalance its economy unless the U.S. itself is ready to fully implement its own policy requirement as part of the coordinated strategy. Specifically, the U.S. should take steps to increase national saving, with a focus, first and foremost, on a major strengthening of fiscal policy.

A number of people have argued, based on econometric work of some kind, that U.S. fiscal consolidation would reduce the U.S. current account deficit only to a very limited extent. I would say that credibility of those results is in question.

For most international macroeconomic analytical issues, my point of departure is the basic Mundell–Flemming model.

- For a small open economy with a floating exchange rate, the model predicts a 100 percent crowding in of net exports in response to action to improve the fiscal position. Domestic saving–investment counterpart to the increase in net exports is the combination of unchanged investment (because the interest rate does not change), unchanged private saving (because GDP does not change) and higher government saving (because of fiscal action).

⁴ I don't agree that Saudi Arabia is part of the framework.

- The two-country version of the model, which is what we should apply to a big country like the U.S., predicts that the crowding in of the net exports would not be 100 percent because lower interest rates resulting from fiscal action would raise investment while the lower GDP predicted by the model would imply reduced private saving. But given the generally low interest elasticity of U.S. investment in the real world, except housing which, however, is only 4 percent of GDP now, and the low private saving rate, I still think that there ought to be a significant crowding in of net exports.

Let me turn to China. China, just like the U.S., should play its part in multilaterally coordinated policy strategy under the aegis of the IMF aimed at resolving the global current account imbalances. First and foremost, it should allow greater flexibility of the RMB. On the question of how much greater flexibility, there are many ways to specify the policy commitment, including in terms of width of the daily fluctuation band for the RMB, in terms of the limit on the size of intervention, and other options.

I am in favor of the greatest feasible transparency in most cases, but when it comes to China's policy commitment regarding the exchange rate under a multilaterally coordinated policy strategy, maybe some limit to transparency should be allowed. This is a detail, but an important detail.

Reform in other areas, particularly in the financial sector, should be part of China's commitment under such a coordinated strategy, but one has to be realistic and anticipate that benefits of those are more for the longer term.

The Fund has become progressively more vocal in calling for greater RMB flexibility. The case the Fund makes when calling for greater RMB flexibility is increased effectiveness of monetary policy that results from it. The basic Fund argument is "Since greater RMB flexibility is good for you, why don't you, might as well, do it in the context of a multilaterally coordinated policy strategy."

I agree that greater monetary policy effectiveness is an important benefit for China. However, our basic case when calling for greater RMB flexibility as part of a multilaterally coordinated policy strategy is that China's current RMB policy looks like something pretty close to currency manipulation for competitive advantage if not in fact it actually is, and the Fund Article IV does not allow such a policy. That Article calls on Fund members to avoid manipulating exchange rates with the aim of preventing effective balance of payments adjustment or gaining unfair competitive advantage over other members. And the Fund is mandated under that Article to exercise firm surveillance over members' exchange rate policy.

Some observers as well as many Chinese officials argue that RMB appreciation, even a large one, would not solve the global current account problems. One would tend to agree that RMB appreciation alone would not bring about a sustainable global current account configuration. However, it is also true that RMB appreciation would certainly be a critical factor if the global current imbalances are to be corrected. In fact, one cannot find a workable coordinated strategy aimed at resolution of global current account imbalances without including as its key element a significant RMB realignment.

In relation to both U.S. fiscal adjustment and China's RMB appreciation, I would suggest that, instead of trying to invent new economics on this occasion with a view to concluding that either one

does not work as advertised, let's practice conventional economic wisdom. Of course, even the conventional economic wisdom that has gone through the test of time won't work in real life in the absence of the determination on the part of the authorities of the countries concerned to carry out the policies that conventional economics calls for.

V. Conclusion

In this paper, I have discussed some of the most pressing policy issues in international economics, especially the fallout of the recent US subprime loan crisis and the policy options for resolving the global current account imbalances. Concerning the ongoing financial market turmoil, I outlined the new IIF initiative for addressing the shortcomings identified by the recent experience, which involves specific steps, among others, to minimize the risks stemming from the originate and distribute business model. I believe that this initiative will contribute to a better functioning market.

Regarding the problem of global imbalances, it is worrisome that non-occurrence, as of yet, of a disorderly global current account adjustment has allowed a sense of complacency to sneak up on some officials and financial market participants. Let me stress that complacency is not warranted. I am particularly concerned about a further intensification of protectionist sentiment which to me is now palpable. The intensified protectionist sentiment will manifest itself in concrete action sooner rather than later, particularly against China. This has to be avoided and that requires an early start of implementation of a multilaterally coordinated strategy to correct the global imbalances involving the U.S., China, Eurozone, and Japan, with the Fund playing a critical role in pushing the process forward.

But is the Fund up to that task? I know that the Fund has to step up to the plate, and I believe the Fund can play a critical operational role, not just a role of a think tank. As I emphasized in Section IV-1 of this paper (see "IMF Surveillance of Exchange Rate Policies: Simultaneous Special Consultations to Address Global Imbalances"), the Fund was created for this kind of purpose, and could work as intended if its management and staff can muster their operational ingenuity and if its major shareholders lend their critical support. Those shareholders ought to know that the huge global current imbalances are a major point of vulnerability of the world economy and that it is wishful thinking to expect any kind of a bilateral solution. The solution cannot be anything other than multilateral, and a multilateral solution cannot be achieved without the Fund effectively playing its mandated role, with full support of its shareholders. There are no other options except assuming away the problem, which I know policymakers as well as economists are very good at!!