

“Global Imbalances: Time for Action”

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Bruegel, in conjunction with Korea Institute for International Economic Policy and Peterson Institute for International Economics published **Bruegel Policy Brief 2007/02 “Global Imbalances: Time for Action”** at a press briefing in Brussels on Tuesday, 27 March (and in Seoul and Washington DC). The brief argues that policymakers should not wait until financial markets initiate the necessary and inevitable unwinding of global current account imbalances. Policy actions are needed *now* in order to minimise the risks of a global downturn and the build-up of protectionist pressure.

The authors argue that adjustment will require “substantial effective depreciation of the dollar” and, therefore, an appreciation of Asian currencies. Whilst European effective (i.e. trade-weighted) exchange rates do not need to change, global adjustment requires that bilateral exchange rates with the US\$ will rise to at least \$1.45/€1 and well above \$2/£1.

The brief is the result of a workshop convened to discuss how to achieve an orderly reduction in the large and unsustainable global current account imbalances. The workshop compared analyses and evaluations of the adjustments required in order to calculate the likely exchange rate adjustments. The participants agreed that global financial integration has helped to make larger and more persistent imbalances more possible today than in the past. However, the situation is unsustainable as persistent external deficits and surpluses of this scale imply an implausible accumulation of foreign liabilities in the US and equally implausible asset accumulation in China and Japan. How long are foreign investors willing to continue accumulating net claims on the United States? At some stage, adjustment must begin.

The brief outlines some important policy implications:

- As U.S. net exports rise, slower domestic demand and most probably fiscal contraction will be necessary to prevent inflationary excess demand;
- Japan and China must accept appreciation of their currencies in order to lead the region on exchange rate adjustment against the US\$;
- Japan must not intervene in bailing out speculators engaged in yen carry trade as the yen appreciates. If it does not appreciate, intervention would be appropriate;
- China should prioritise the promotion of domestic demand rather than relying on the export sector. This process should be initiated by a 10% step revaluation of the renminbi in the near term;
- Europe should not resist appreciation of the euro and sterling against the US\$ in the context of global adjustment, provided they do not appreciate in effective terms.

An international effort is required to persuade each country or entity to contribute its fair share to adjustment as individual countries are unlikely to come up with a coherent package independently. The IMF’s upcoming spring meetings provide a crucial opportunity to agree on an adjustment package of the kind advocated in this policy brief.

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