

## Summing-Up

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1. It is striking that there is broad agreement on the nature of the problem of global imbalances, and on what changes in the global economic situation will be needed to deal with the problem. Although there are some nuances in the analysis of the problem on which a judgment needs to be formed, this is not a situation in which further research is likely greatly to clarify the situation.
  
2. The accepted analysis is that of the Fund staff and of the pre-conference:
  - that the current account deficit of the U.S. is due to a sustained decline in the US national saving rate and a corresponding excess supply of saving in the rest of the world, particularly currently in Asia – especially Japan and China – and among the oil producers;
  - these imbalances are revealed in the current account deficit of the United States and the large surpluses particularly of China, Japan, and the oil producers;
  - that the situation cannot go on forever, though it is very hard to know when it will stop;
  - that a sustainable current account deficit for the US is about 2.5-3% of GDP, a decline in net absorption of over 3% of US GDP, or 1% of global GDP (using market exchange rates). This change could be implemented over several years, but it is nonetheless so large that it could – if things go wrong – create a serious global recession;
  - that as part of the solution to the present problem, (a) domestic demand in the deficit countries will have to fall relative to supply; (b) domestic demand relative to supply should rise in the surplus countries; and (c) that in the process, the value of the dollar will have to decline relative to other currencies, in particular that of China;

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- that this could happen either, (a) as a result of coordinated action by the major countries involved, along the lines of the G7 strategy laid out by John Taylor in his paper prepared for this conference,<sup>1</sup> which includes greater flexibility of the renmimbi, which will presumably lead to its appreciation along a trajectory similar to that followed earlier by the currencies of other Asian miracle economies, or, (b) as a result of market forces that cause a decline in the dollar that is an essential component of a process that gradually and possibly painfully produces the required current account adjustments. Other components of that process could include higher interest rates and lower stock prices in the US, and US monetary policy tightening intended to offset the inflationary effect of the depreciation of the dollar.
3. The main questions that need to be answered are (i) if the diagnosis is clear and agreed, why has so little been done so far; (ii) in what sense can this situation not go on forever; (iii) what is the most likely scenario, and how likely are the different scenarios; (iv) if the dollar adjusts rapidly, will that create a global financial crisis; and (v) what next, and what is the role of the IMF?
4. Why has so little been done?
- Although we say it is in the interests of everyone to make the needed adjustments, that is evidently not how the relevant economic policymakers see it – in the US, in Europe (where the strategy calls for structural economic reforms to promote growth), and in Asia.
  - To put it another way, everyone wants the US to take care of its current account deficit. But no-one is particularly perturbed to have a current account surplus, except perhaps the Central Bank of Russia, which has to struggle to contain inflation in Russia as the massive current account surplus pushes the rouble to appreciate. For instance, we in Israel are

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<sup>1</sup> John Taylor, “Economic Reform and the Current Account: Implementing the Strategy”, material for the Conference on Global Imbalances, IMF, April 21 2006.

delighted to have a surplus in the current account for the first time in over half a century.

- Why is almost everyone happy to have a current account surplus? I see three reasons. In the first instance, in the words of the IMF Staff's note for this conference, "...the policies espoused in this strategy are in the *medium term* interests of the individual countries ..." (emphasis added). That is to say, they are not obviously in the short-term interests of the individual countries.
- Second, the mercantilist instinct is very deep. In addition, the experience of the 1990s has persuaded policymakers that it is not good to run a large current account deficit, which in most countries is translated into the view that a current account surplus is better than a deficit.
- The third reason that not much has been done in the context of multilateral action is that the last two occasions a multilateral bargain was struck, one major player deeply regretted the bargain later. This happened with the coordinated action following the Bonn Summit of 1978, which Germany regretted later as having contributed to inflation. Similarly, some in Japan saw its country's role in the coordinated action of the 1980s as having contributed to its asset price bubble and subsequent lengthy recession.
- The absence of desire to act is not a small thing. The reason so little has been done is that no-one aside from economists is particularly upset by the current state of economic affairs. Much of what goes on in the policy discussions is an attempt by each country to transfer the responsibility for dealing with the problem to some other country.
- The case for acting now is greater if we are staring disaster in the face. But while those who predict disaster may be right, they have been crying wolf too long to be persuasive. We do not know whether we are like those falling from a tall building on the way down, or simply people with their feet firmly on the ground who do not understand the new world of capital mobility and sophisticated capital markets in which they live.

5. This brings us to the question of in what sense this situation cannot go on forever:

- What cannot go on forever is a US *trade and services account* deficit of approximately the current magnitude of 6 percent of US GDP. A *current account deficit* of 6 percent of GDP *could* be a steady state for the United States – under reasonable assumptions<sup>2</sup> that would put the steady-state US external debt/GDP ratio at 200 % and require a trade and services account surplus of 4% of GDP to service the current account deficit. Such a steady state would require about a 10% of US GDP switch in the trade and services account during the transition to the new steady state. That could be done over a very long period, but it would be a massive adjustment.
- The big question is whether and on what terms the rest of the world would be willing to hold such a large amount of US assets. If we believe that capital output ratios are in the range of 3 - 4, then on net foreigners would be holding half the US capital stock, and Americans would on net be very poor asset-wise, relative to the rest of the world.
- The main argument that the current situation cannot continue is that foreigners are either very close to or already at the stage when they are no longer willing to hold increasing amounts of US assets. The shift in the financing of the current account deficit from net equity flows to foreign central bank financing is part of the evidence for this view.
- Of course, the willingness of foreigners to finance the deficit depends on expected returns from investing in the United States. Part of that return takes the form of a very low risk premium that the United States enjoys as a result of its political stability and the breadth, depth and efficiency of its capital markets. The low risk premium – the fact that the US is a safe haven for foreign investors – accounts for some of the dark matter phenomenon.

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<sup>2</sup> The assumptions are a growth rate of 3% and a real return on assets of 5%.

- If there is a sudden change in foreigners' willingness to buy American assets, the dollar will drop until, in Dornbusch-model fashion, it has fallen far enough to persuade foreigners to finance the current account deficit.
- As a result of that depreciation, the trade account will begin to rebalance – but that would be a lengthy process. The process would be expansionary for the United States, and contractionary for the rest of the world.
- If interest rates rise and asset prices in dollars fall during this process, the result could be a recession in the US. But that outcome is not certain, and it is possible that the dollar adjustment could take place sufficiently smoothly for the US to avoid a recession.
- It would be more difficult for other countries to avoid a recession without taking expansionary policy actions.

6. What is the most likely scenario, and how likely are the different scenarios?

I put the question in this form deliberately, since no-one knows what will happen, and no-one should be confident that they know. Let me add that most calculations that are viewed as pessimistic in that they require a large exchange rate adjustment, including some by Ken Rogoff, suggest that the adjustment process would require a change in the value of the dollar of about 20-30 percent.

One is also impressed that in the papers we have seen, including that of the Fed staff for the pre-conference, none of the changes we all recommend seem to have major quantitative effects. I sometimes wonder whether there is a general errors in variables type of problem in econometric modeling of the impact of policies, in which it is hard to measure these impacts because policy experiments are so rarely clean.

- To my mind the most likely scenario (Scenario A) is one in which the dollar continues to decline by fits and starts over a period of years,

possibly a decade, possibly longer, helped along by greater flexibility of Asian exchange rates, including that of China. This process will be helped by occasional fiscal corrections in the United States, and by a declining saving rate in East Asia, particularly in China, in part as a result of improvements in the capital markets and in social security and other welfare systems. It would also be helped along by a more expansionary monetary policy in Europe in response to the appreciation of the euro against the dollar.

- I do not think this scenario will play out quickly or clearly. Rather the dollar will be in a trend decline with significant movements around trend, for instance last year's dollar appreciation. Similarly, there will be a trend in movements in the US trade account and in net foreign absorption, with cyclical movements superimposed on the trend.
- This is not a process in which we are likely to see a major recession in either the United States or in the appreciating countries.
- It is unlikely that there will be a sudden and dramatic change in the demand for dollar assets by foreign central banks. It is more likely that the foreign private sector will show increasing reluctance to finance the US current account. But because of the strength of US capital markets, and an underlying confidence in the strength of the US economy, it will not take major declines in the dollar to persuade foreigners to invest in the US.
- Nonetheless there is an alternative Scenario B. In this scenario, an unexpected event, or a tipping point that is reached by the gradual accumulation of doubts about the US economy, precipitates a collapse of the dollar. This could be accompanied by rising long-term interest rates as foreigners move out of American bonds, and by a serious stock market decline. And monetary policy might have to react to an increase in inflation brought on by the dollar decline. This would produce an American recession, which could contribute significantly to reducing the current account deficit, but also to producing recession in other countries.

7. The fourth question is whether a rapid adjustment of the dollar will necessarily create a global financial crisis? I believe the answer is no. I believe the capital markets are much stronger than they were a decade ago, and that the advent of more sophisticated risk management methods by both financial and non-financial institutions enables them to deal with shocks with far less stress than was possible even a decade ago. Thus the dollar could decline a long way without having a major disruptive effect on firms and on markets. That would mean the exchange rate adjustments needed to deal with the current imbalances could occur without a financial crisis. And if monetary policy makers could to some extent accommodate the one-off effects of the change in the value of the dollar, a US recession would be less likely.

Such a scenario, Scenario C, may sound implausible. But we should remind ourselves that the dollar-euro exchange rate moved from 80 US cents per euro to \$1.30 per euro within a period of three years, without producing a financial crisis or major disruption. Such a smooth price adjustment would produce a less rapid change in the current account. But that surely would not be a matter for concern.

So what are the probabilities? If constrained to give a single number for each probability, I specify that the probability of scenario A is 45 percent, that of B is 35 percent, and that of C is 20 percent.

8. All that is left is to decide what to do about the problem. The probabilities indicate that there is a significant chance of a disorderly adjustment that could produce a global recession. So we should take preventative action. Those actions should follow the advice of the Fund staff – US fiscal consolidation, financial reform globally, European structural reform, and Asian exchange rate flexibility, especially in China. And while we are at it, we should also ensure the success of the Doha Round.

And what should the Fund do? In these circumstances it has no executive authority, it can only aim to persuade. And it can persuade only by talking, by consulting, by mobilizing public opinion. Thus it needs to keep banging away

at this problem, including through conferences like this one, in bilateral consultations, in multilateral consultations, and in the speeches and public appearances of the Managing Director and other leaders of the Fund. Possibly nothing will be done until the dangers of the situation become more imminent to the economic decision-makers, but if and when that moment arrives, it will be very clear to everyone what needs to be done.