Economic Reform and the Current Account: Implementing the Strategy

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I first review the strategy that the G7 and other countries have recently pursued toward the current account. I then ask whether that strategy or its implementation should be changed or improved.

Dealing with the Global Downturn

Although the current account deficit of the United States—and its mirror image the current account surplus of the rest of the world—had been increasing steadily through the 1990s, international economic policy during 2001-2003 turned to dealing with problems of recession in the United States, a global downturn, the 9/11 attacks, and financial crises in emerging markets. Thanks in part to the policies chosen to deal with these problems—including the cuts in tax rates and interest rates in the United States—the global economy recovered, and was on its way to a more sustainable expansion by the fall of 2003.

By this time it was also clear, however, that the current account deficit was continuing on the upward path started in the 1990s, and as a result the net foreign indebtedness position of the United States was rising, and would rise as a share of GDP unless the current account deficit as a share of GDP began to come down again. To be sure, there were some doubts about the true size of this indebtedness position because the net income flows on investments still favored the United States, an anomaly that has generated many academic papers and much debate.

Nevertheless, most international economic policy makers decided to focus explicitly on the current account. In the fall of 2003, the G7 finance ministers and central bank governors put forth a strategy to deal with the current account. They based

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their policy on the basic economic principle that the current account imbalance was due to the gap between saving and investment. It was a three pronged strategy.

The Three Pronged Strategy

The first part of the strategy was to *raise saving in the United States*, both by reducing the structural budget deficit as a share of GDP and by removing distortions that discourage saving. The second part was to *raise economic growth and investment in the rest of the world*—especially in Europe and Japan. Because the global economy would soon be in the expansion phase where potential GDP would set the pace for growth, the emphasis was not on demand side policies but rather on structural economic reforms that would raise potential GDP growth and shift the composition of spending away from consumption in the United States and toward investment in the rest of the world. The third part of the strategy was to *increase exchange rate flexibility* in order to facilitate the adjustment of the current account over time. Because the major source of exchange rate rigidity was the Chinese peg, this part of the strategy would also require economic reform, in this case reform of the exchange rate regime in China.

The elements of this strategy were first put forth in the G7 communiqué issued at the annual meetings of the IMF and World Bank in September 2003. It called for "ensuring medium term fiscal sustainability," it insisted that "structural reforms must be accelerated, and it emphasized that "more flexibility in exchange rates is desirable." To encourage implementation of this strategy to "redress global imbalances," the G7 also issued an Action Plan called the Agenda for Growth, which was intended to move G7 discussions from the demand side to the supply side. Sub-cabinet groups (such as Working Party 3 of the OECD) shifted the agenda accordingly, and began devoting time to how structural economic reforms related to the current account. Soon the G7 Agenda for Growth was expanded into the G20 Accord for Sustainable Growth.

In developing this strategy, the G7 followed the important principle that they should "do no harm." For example, two other policies that could have reduced the gap between saving and investment were to lower investment in the United States and lower saving in the rest of the world. These were rejected by the G7. Global saving was not high by historical standards. According to IMF data, global saving was only 21 percent of GDP in 2003 compared with 25 percent in early 1970s. Calling for an even lower saving rate in the rest of the world seemed like a harmful policy at the time. Another policy that was rejected was to lower economic growth in the United States. Though it would have lowered imports, such a policy would have caused harm throughout the world as well as in the United States.

In addition to doing no harm, the three pronged strategy could actually do some good independently of the current account. For example structural reforms in Europe would reduce unemployment, and a flexible exchange rate in China would allow monetary policy to work more efficiently as controls on capital flows were reduced. If implemented, the strategy would also demonstrate that the international community was trying to work together in facing up to real problems, rather than simply talking about them.

Implementation of the Strategy

The implementation of parts one and two the strategy would have to be carried out in individual countries because the structural reforms involved changes in legislation or regulations within countries. The G7 countries, with great help from the IMF and OECD research staffs, tried to monitor what each other country in the G7 was doing. To assist in this effort, the OECD created a new annual series, called "Going for Growth", a novel form of benchmarking surveillance that measured progress on structural reforms. In addition to creating this benchmarking methodology, there is some progress on the reforms to report, though more needs to be done. For example, "Going for Growth 2006" notes progress in reforms of "competition-restraining regulation." Another example is that the federal budget deficit in the United States came down from 3.5 percent of GDP in 2004 to 2.6 percent of GDP in 2005.

The implementation of part three of the strategy required action in China, but also an explicit G7 exchange rate diplomacy with China. Thanks to a well coordinated multilateral effort, in September 2004, a year after the original September 2003 communiqué, the Chinese finance minister and central bank governor joined a G7 meeting to discuss the Chinese currency issue. It was the first time the Chinese met with the G7 finance ministers and central bank governors. The following summer, in July

2005, the Chinese ended the peg, and they have been gradually moving toward more flexibility ever since. Hence, there has also been some progress in implementing part three of the strategy.

Despite this progress, there has been no noticeable impact on the current account. Simulations of econometric models by the Federal Reserve Board staff and by the IMF staff have shown that the lags are long and the impacts rather small, so the lack of an impact should not be surprising. The Fed and IMF simulations are a reminder that most of the changes of the current account over time will occur as the private sector makes adjustments over time.

What are the Risks?

In the meantime, some people continued to raise concerns about possible risks to the currency markets and even the global economy from the current account deficit. For example, on January 5, 2004, former Secretary of the Treasury Robert Rubin warned that the growing U.S. current account deficit could cause a currency crisis, risking a "loss of investor and creditor confidence" and "disruptions to financial markets." Two days later the IMF staff released an occasional paper with a similar theme, stressing "significant risks to the rest of the world" from the U.S. fiscal and current account deficits, and the authors held a formal press conference to get the word out. The next day, January 8, the *New York Times* featured the IMF study on the front page above the fold with the headline, "IMF says Rise in US Debts is Threat to World's Economy."

There was no justification for such alarmist headlines. A more accurate headline would have been "U.S. Tax Cuts Saved World's Economy." Indeed the alarmist statements were more of a risk than the current account itself, and policy makers tried to alleviate the concerns generated by such statements, while at the same time not being complacent. (See for example my remarks, "The U.S. Current Account: Recent Trends and Policies," American Enterprise Institute, Nov. 4, 2004). It is true that the historical correlation between the exchange rate and the current account is negative, and this does indicate that the dollar and the current account deficit would be expected to come down together, but that does not imply any sharp crisis-like movements. Indeed, the time series pattern of the historical correlations suggests a gradual exchange rate adjustment, and because the correlation is not perfect you may not even see the adjustment for a while. Moreover, the correlation is no reason to try to talk the dollar down, and such a policy was not undertaken by the U.S. Treasury. The exchange rate is not a separate instrument of policy; it adjusts as other policies change, especially under an exchange rate regime that emphasizes avoiding exchange market intervention, both directly and verbally. Finally, no central bank is going to dump suddenly massive amounts of foreign exchange, when that action would affect the exchange rate and harm their own economy.

Unfortunately the econometric models are not helpful here, at least as currently used. The crisis simulations conducted by the IMF (reported in Appendix 1.2 of the September 2005 World Economic Outlook) are not based on hard evidence of what causes crises. They provide absolutely no evidence that a crisis is more likely with a larger current account deficit than with a smaller deficit. They simply assume that there is a crisis, in the form of a sharp depreciation of the dollar, which is then passed through to inflation causing the Fed to tighten and causing a sharp downturn in economic growth. The speed and the size of the depreciation are apparently "made up," not part of the model.

Change the Strategy or its Implementation?

For the most part this three pronged strategy has remained in place for the past two and a half years. Given this review one can then ask: Should the strategy be changed? Should more be done to implement the strategy? Are there new policy ideas worth considering? In my view, it is best to build on the existing strategy—rather than scrap it and start over—by placing more emphasis on implementation.

There is wide agreement that the current account results from saving and investment imbalances and that flexible exchange rates aid in the adjustment, so the strategy is based on sound economic principles. Another advantage is that it is multilateral in concept, involving communiqués among the G7 and beyond. In fact, more could be done to communicate about the existing multilateral strategy, as it is still not widely understood.

Implementing all three parts of the strategy could be improved. For example, expanding the new health saving accounts in the United States would increase private saving. Taking additional steps to increase exchange rate flexibility in China would help in the adjustment. Perhaps the most significant improvement in implementation could come from placing more emphasis on increasing investment in the rest of the world. By emphasizing higher growth around the world, part two of the three-pronged strategy has thus far left the needed increase in investment implicit. Making it explicit would be an improvement. More emphasis should be placed on reforms that make countries outside the United States more attractive places to invest.