When the G-20 gathers in November, continuing uncertainty about the prospects for global economic growth and worries about the risks posed by global financial imbalances are likely to dominate the talks.

US economist Menzie D. Chinn argues that while there appeared to be a consensus early on in the recent financial crisis about the policy mix needed to address both issues, divisions have since emerged. Both developed and developing countries need to rethink their approaches, or the consequences could be harmful for the world economy, he says.

ONLY A FEW MONTHS AGO, policymakers around the world were confronted with a series of challenges that, while substantial, seemed relatively well defined. International organizations such as the International Monetary Fund and the Organization for Economic Cooperation and Development highlighted the challenges of a twospeed recovery: emerging markets racing ahead, advanced economies plodding along. Global financial imbalances, particularly in current accounts, were a worry, but there were promising signs that growth and rebalancing in the United States and China would prove durable.

The prospects for a sustained global recovery now seem much less certain. Most forecasters have revised downward their estimates for growth in the US and Europe. Anxiety over the durability of Chinese growth remains. Against this backdrop, the resurgence in the US trade deficit combined with the reluctance of the Chinese to allow further currency appreciation suggests that sustaining both growth and rebalancing will be much more difficult than policymakers earlier believed.

The failure of the US to further expand short-term fiscal and monetary stimulus—despite ample evidence of economic slack and little evidence of inflation or crowding out—means that policymakers in other countries must step into the breach if a global recovery with rebalancing is to be effected.

Greater fiscal stimulus in the current account surplus countries and greater currency appreciation on the part of the East Asian economies will be needed. In the absence of forceful action, a relapse into global stagnation and widening imbalances is likely.
Economic growth and employment growth are the key challenges in the advanced economies. However, there are speed limits to that growth, ultimately imposed by the growth rate of potential gross domestic product (GDP). Hence, a better way of looking at the challenges facing policymakers is to consider how to attain internal and external equilibrium. Internal equilibrium refers to getting output up to normal levels, namely potential GDP; in the absence of other shocks, that level of output should be consistent with non-accelerating inflation. External equilibrium refers to getting the current account to a level consistent with a given country’s development and fiscal policies. A rough impression of the amount of slack in the world economy can be gleaned from Figure 1, which shows the output gap for the three major advanced economies and an aggregate for Brazil, India and China, as well as forecasts from the IMF and World Bank.

Figure 1 highlights the dichotomous nature of the world economy; the advanced economies are stuck with tremendous economic slack, while emerging market economies are operating above potential. The current account imbalances are shown (as a share of world GDP) in Figure 2 overleaf. The global recession, which hit the US particularly hard, has reduced the US current account deficit. However, the IMF forecasts a resurgence in the US deficit, and a concomitant increase in surpluses for China and emerging Asia.

The challenge is to push output upward toward potential in the advanced economies, while simultaneously reducing current account deficits in the US. In select emerging market economies, the objective is to manage an approach to potential GDP while shrinking current account imbalances.

**THE ADVANCED ECONOMIES**
The US is the key to rebalancing the world economy. However, effective policymaking has been hampered by misconceptions. First, concerns about overheating in the US are much too
overblown. The IMF indicates a 2010 output gap of only about -4 percentage points of GDP, while the OECD and the Congressional Budget Office (CBO) project -5 and -6 percentage points, respectively. The recent downward revision in US GDP (almost a percentage point) suggests that the output gap is even larger in absolute value than indicated in the various estimates, and further lessens the urgency to retrench fiscally.

The fear that the economy is nearing its speed limit is linked to the fear that the natural rate of unemployment has spiked, driven by the suspicion that with the change in the composition of output, the labor market mismatch has increased. The argument has some validity, given the large proportion of long-term unemployed — the highest on record. However, most estimates do not ascribe more than a small proportion of the increase in unemployment to a rise in the natural rate.²

The evidence of substantial slack in the US economy is buttressed by the fact that inflation is flat and likely to stay flat. Survey-based measures of inflationary expectations have not budged, even at the 10-year horizon. Market-based measures, such as the spread between inflation-indexed bonds and US Treasury yields, also support this conclusion. If anything, fears of deflation have risen.

The misguided fear that the US is nearing a tipping point with respect to government debt has constrained fiscal policy. The US has long-term fiscal problems largely due to rising entitlement spending and the refusal to raise sufficient tax revenues; the latest recession, and particularly the 2001 and 2003 tax cuts, merely magnified the problem. But the US still has some latitude for fiscal stimulus in the short term, as documented by Ostry et al. (2010). If there is a medium-term problem, the solution is not to retrench now, but to conduct countercyclical fiscal policy while setting forth a plan for medium-term fiscal consolidation.³

Prospects in the US for rebalancing the current account are more difficult to assess (see figure 3), in part because the process depends upon what happens in the rest of the world. The IMF projects a gradual increase in the US current account deficit. Given the current constellation of exchange rates, particularly with respect to China, and the failure of Europe to expand rapidly, it is hard to see why these projections should prove substantially incorrect.⁴

A sustained and prolonged depreciation in the US dollar would change the outlook. Figure 4 shows the correlation between the trade balance, roughly equal to the current account, and the dollar’s value (lagged by two years).
also highlights the fact that oil accounts for a large share of the trade deficit. With little action toward a reduction in oil imports, the US trade deficit remains very susceptible to a rebound in oil prices.5 Nonetheless, there is room for optimism, at least on the rebalancing front. If US households appear to be retrenching more than had been earlier anticipated, household saving rates have not declined, according to the most recent statistics. The mirror image of this is that aggregate demand will not have an upward push from domestic sources, so slack is even more likely than overheating. This also means that imports — at least of consumer goods — will not pick up as much as otherwise. In other words, what helps in hitting one target hinders in hitting another target.

What about the euro area and Japan? The euro area remains at approximate current account balance. Furthermore, without clear evidence of structural change in Japan, the IMF is projecting continued surpluses, although the recent yen appreciation will certainly work in the opposite direction. If rebalancing is to proceed apace, we cannot rely upon the rest of the advanced industrial countries to contribute very much to the adjustment process.

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**FIGURE 3** CURRENT ACCOUNTS AS A PERCENTAGE OF GDP: US, EURO AREA & JAPAN
Shaded area denotes forecasts.
Source: IMF, World Economic Outlook (April 2010)

**FIGURE 4** CORRELATION BETWEEN US DOLLAR EXCHANGE RATE AND RATIO OF US NET EXPORTS TO GDP
Left scale shows log exchange rate (rise denotes depreciation); The right side shows the ratio of net exports to GDP.
Source: BEA, Q2 2010 advance release, Federal Reserve Board, and author’s calculations
This conclusion has even greater force in the wake of the sovereign debt crises in Europe. The southern European countries are, appropriately, implementing programs of fiscal consolidation. However, the countries that have fiscal space — namely Germany and to a lesser extent France — are failing to implement programs to stimulate their economies. Certainly, there are few moves to encourage additional private consumption in these countries. The policy thrust in the northern euro area is pointed in the wrong direction for both rebalancing and sustaining growth.

THE LARGE EMERGING-MARKET ECONOMIES
The problems facing emerging-market economies are substantially different from those facing advanced economies. Turning first to external balances, the current account balances of Brazil, Russia, India and China are depicted in Figure 5. The most notable of these is Russia’s, which is projected to slide to zero by 2015, and China’s, which is projected to resume expansion. The trade balance proportion is slated to stay relatively constant at 2010 levels; the net factor income proportion expands as receipts on foreign assets increase.7

If there is a danger of overheating, it’s in the emerging markets. Prior to the global recession, Brazil, India and China all had substantial output gaps, at roughly 3 percentage points in 2007 (see figure 6). Forecast output gaps for 2010 are all in the positive range, save for Russia, which has been negatively affected by the slump in energy prices. One worrisome feature is the trajectory of the output gap for India, which is slated to rise to above 5 percentage points by 2012.

China merits additional discussion because of its central role in global current account imbalances. There are a couple of ways to examine this issue. The first is the conventional “elasticities” view, where the impact of Chinese currency misalignment is assessed in a partial equilibrium approach. The second is more macroeconomic, viewing the current account as the outcome of saving and investment and government budget decisions. The latter approach does not necessarily exclude the former; rather, it changes the focus.

Has China’s misalignment of the yuan driven the surge in its trade surplus? The trade-weighted real value of the yuan, and the Chinese trade balance, are illustrated in Figure 7.

The fact that the yuan appreciates even as the trade balance surges does not invalidate the proposition that exchange rates can have an impact. Exchange rates typically appreciate as countries experience rapid economic growth.8 Nonetheless, the empirical evidence regarding the strength of exchange-rate effects on Chinese trade is not definitive. Studies using Chinese data predating the recent recession find some effects of the exchange rate on Chinese exports, but do not typically find correspondingly large and statistically significant effects on imports.

More recently, using data spanning the recent recession and the rebound (from the first quarter of 1996 to the second quarter of 2009), Ahmed (2009) finds that in the long run, a one percentage point increase in the annual rate of appreciation of the real exchange rate would have a cumulative negative effect on real export growth of 1.8 percentage points. This means that after four years, a 20 percent yuan appreciation would induce a $400 billion decrease in Chinese exports. In contrast, Cheung, Chinn and Fujii (2010), using data predating the Great Recession, find a $50 billion impact. In addition, it is likely that a yuan appreciation would induce a region-wide appreciation of currencies against the dollar. That development would definitely facilitate the further dollar depreciation essential to American rebalancing.9

A second way to examine the issue of Chinese rebalancing is through the lens of saving and investment balances, which highlights the fact that
FIGURE 5 CURRENT ACCOUNTS AS A PERCENTAGE OF GDP: CHINA, INDIA, BRAZIL & RUSSIA
Shaded area denotes forecasts.
Source: IMF, World Economic Outlook (April 2010)

FIGURE 6 OUTPUT GAPS AS A PERCENTAGE OF GDP: CHINA, INDIA, BRAZIL & RUSSIA
Shaded area denotes forecasts.
Source: World Bank data as of June, 2010; personal communication

FIGURE 7 CHINESE YUAN EXCHANGE RATE AND CHINA’S TRADE BALANCE
Left scale shows log real effective exchange rate (rise denotes depreciation); Right scale is annualized trade balance (US$ billion).
Source: IMF, International Financial Statistics and author’s calculations
the current account is related to the budget balance and the gap between private saving and investment. This perspective shifts the focus to Chinese private saving (both households and the corporate sector), as well as to government saving. In contrast to the mid-2000s, when the surge in corporate savings was identified as a key factor, more recent analyses have focused on the elevated levels of all three components (Ma and Yi, 2010; Prasad, 2009).

Some of this is due to the trend decrease in the share of labor income in Chinese GDP. This phenomenon, combined with the relatively high household saving rate, means that merely trying to raise the household saving rate (by improving the social safety net and increasing access to consumer credit) cannot in and of itself solve the problem. Hence, rebalancing involves a rebalancing of the domestic shares of income away from capital.

This point has become increasingly central, as the debate has moved to whether wage rates are rising. Those familiar with the Lewis (1954) and Fei-Ranis (1964) model of development will recall that as wages rise, the share of income going to capital decreases. If the propensity of labor to save is less than that of capitalists, then the saving rate should decline (Kroeber, 2010). It might be that this is the natural outcome of the tightening of the labor market in the coastal provinces. Even if that is true, the process of raising household savings (in aggregate terms, not just as a share of household income) can be accelerated by aggressive government action to reduce uncertainty by developing the health and social insurance networks, as suggested by Prasad (2009).

In sum, there is scope for Chinese government policy to accelerate rebalancing. In the short term, this involves faster currency appreciation. Over the longer term, it will require allowing state-owned enterprises to pay dividends, reducing the monopoly power of state-owned corporations and accelerating the development of a social safety net that will reduce incentives for household saving, while decreasing government saving.

POLICY IMPLICATIONS

There is little chance of overheating in the short term in the US, or other advanced countries. Rather, the greater risk is of deflation, combined with stagnant growth. On the other hand, with the likelihood of a two-speed global recovery becoming ever more apparent, the possibility of overheating is more pronounced in emerging markets.

Global adjustment of current account balances is not proceeding apace — at least not with the current configuration of policies. Continued consumer retrenchment in the US will help reduce the US current account deficit, but northern European fiscal retrenchment is not helpful. In addition, the failure of the Chinese (and other current account surplus countries) to resume currency appreciation means that the quickest means of effecting some adjustment has been put on hold — and cannot be deferred indefinitely. At some juncture, high unemployment combined with a burgeoning trade deficit will increase the likelihood of a destabilizing trade conflict.

A textbook approach to stabilization policy, given the large amount of slack in the American economy, suggests that the US should undertake additional fiscal stimulus, and extend quantitative and credit easing. Since it is unlikely that there will be much progress along these lines, the successful transition to a growth trajectory combined with rebalancing will require more — not less — initiative on the part of policymakers in Europe and Asia. In those countries with some fiscal space, greater stimulus should be undertaken.

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NOTES
1. The mean forecast for growth in the second half of 2010 was 3.05% in early May; by early August, it had dropped to 2.6%, according to The Wall Street Journal.
2. Weidner and Williams (2010) work off Okun’s Law (for every 1 percent increase in unemployment above a “natural” level, GDP will decrease from 2 to 4 percent from its potential) to calculate an increase of 2.8 percentage points from the fourth quarter of 2007 to the first quarter of 2010. A more micro-based approach is adopted by Dowling, Estevão, and Tsounta (2010), who directly address the skills mismatch issue. They estimate the natural rate has risen 1.5 percentage points.
4. Bertaut, Kamin and Thomas (2009) use the Fed’s partial equilibrium model to forecast a similar trajectory for the US current account deficit.

REFERENCES
World Bank, 2010a, China Quarterly Update (Beijing: World Bank, June).

10. There has been some debate whether such appreciation endangers China’s growth too much. On one side is Dani Rodrik (2008). On the other side is the IMF (2010) and Eichengreen and Rose (2010). 11. Chinn and Ito (2007, 2008) document the fact that for developing countries increases in government spending can induce a reduction in the current account balance. They also verify that financial development cannot be depended upon to reliably decrease Chinese current account balances, in contradiction to the Bernanke (2005) saving-glut thesis.
12. Additional measures relating to financial regulation are in Chinn, Eichengreen and Ito (2010), and Eichengreen (2010), while Eichengreen (2010) proposes measures in additional policy areas, including fiscal and monetary policies.