

**Policy Cooperation**

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**For the 75<sup>th</sup> Anniversary of the  
Bank for International Settlements,  
Basle, Switzerland**

**Wednesday, June 29, 2005**

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The subject of this panel, policy cooperation, has several meanings. When I became chairman of the International Financial Institution Advisory Commission, two people who are well acquainted with the Bank for International Settlements advised me separately that the Bank plays an important role, one that they valued highly, in promoting understanding and, at times, cooperation. Since I respect and admire Hans Tietmeyer and Alan Greenspan, I accepted their view that the regular meetings of central bankers at this Bank promoted understanding of the political constraints under which some central banks operated and encouraged cooperation. This is one, useful, but relatively narrow meaning of central bank policy cooperation.

A second, and to me less appealing, meaning, takes the form of exchange rate coordination. Countries agree to adjust their nominal exchange rates by changing domestic policies. Examples include the 1936 Tripartite Agreement between Britain, France, and the United States or the efforts in the 1970s to convince Germany to expand more rapidly to help the United States. Proposals of this kind often require actions that are opposite to the policy actions countries would choose in the absence of coordination. For example during the late 1970s, the United States wanted Germany to inflate somewhat faster to prevent nominal dollar depreciation. The German response was, in effect, that the same result could be achieved by less inflation in the United States. Coordination of this kind often fails.

A third kind of policy coordination is the topic I want to address. I propose coordination by the United States, Asian and European countries to the growing imbalances in the world economy. The proposal I offer asks countries to agree to policies that are in their own long-run interest but also each others. Political concerns in each country keep them from adopting these policies unilaterally. Mutual agreement – coordination – may be a way of breaking the stalemate.

There are two or more views about current imbalances. A large number of studies by Mann (2003), Obstfeld and Rogoff (2004), Truman (2005), Roubini and Setser (2004) and others argue that the U.S. current account deficit is “unsustainable.” They produce evidence from econometric models showing that the U.S. current account deficit will rise to 8, 10, or even 12

percent of U.S. GDP. One can cite Herbert Stein's dictum that unsustainable trends end. The question is: how do they end? Most of these authors respond that they end with a crisis, a collapse of the dollar, perhaps a world financial and economic crisis.

Let me interject that I do not find these arguments appealing, and, more relevant, long-term interest rates and expected change rates show no evidence that markets put much weight on these forecasts. Even less appealing is the frequent conclusion that the United States should act now, unilaterally, to curtail domestic demand and increase national saving. There are three reasons.

First, I do not believe the casual argument that a smaller reduction in U.S. aggregate demand now should be preferred to an uncertain larger reduction later. Perhaps. Perhaps not. Both the future and the predictions of crisis are too uncertain to accept that claim.

Second, and most important, some policy simulations that the authors produce suggest that to get a 20 percent devaluation of the nominal dollar exchange rate, with Asian exchange rates pegged to the dollar, requires an 84 percent appreciation of the euro, a change to about 225 euros to the dollar. With 20 percent appreciation in Asia, the euro reaches about 185 to the dollar and the yen appreciates to 85. Truman (2005, Table 5) These are very large appreciations for relatively slow growing economies, in the case of Germany and Japan economies dependent currently on export growth.

Third, most proposals for unilateral action by China or the United States seek one-time adjustments in the U.S. current account as a percent of GDP. They do not ask whether, after the adjustment, China's growth rate would be high enough relative to the U.S. so that the problem would return at the new exchange rate for the renminbi. If they are right about a coming crisis, and I am skeptical, they should seek a permanent or sustainable solution.

There is another side. Many writers suggest either that the problem is likely to be solved in an orderly way or that the current account deficits are sustainable. There are many variants that I associate with Alan Greenspan (2003), Ben Bernanke (2005), Richard Cooper (2004), Alan Stockman (2005), and Michael Bordo (2005).

The simplest argument, and one that I have made elsewhere, is that much of the world and especially China are modern mercantilists. To create employment China undervalues its currency to promote its exports. Some estimates suggest that China has 150 million workers unemployed or underemployed. For comparison, that is more than the entire U.S. labor force.

China willingly subsidizes exports by as much as 1 or 2 percent of its GDP. The rest of the world, especially the U.S., gets consumer goods and inputs for its domestic production in exchange for pieces of paper that are costless to produce. Why complain?

The main concern is, again, that the system is unsustainable. Critics could not imagine that China would want to hold \$600 billion or more in dollar assets. Double or triple that amount strains their credibility past the breaking point. Perhaps they are right. But perhaps China values employment of the 150 million more than the possible loss from holding enormous reserves.

A second concern is less often advanced. The arrangement leaves the United States economy undercapitalized and the Chinese economy overcapitalized. In effect, China builds the capital stock to produce the goods that the U.S. and others consume. At some point, that will change with possible business cycle type consequences.

Third, there are transitional and possible permanent costs. Workers in the importing countries lose jobs. The unemployment rate in the United States is close to full employment, but many of the new jobs are said to have lower pay or fewer benefits. And in Europe, the unemployment rate remains high. Imports are by no means the principal or only reason, but they are a visible and politically potent reason.

One result is political pressure to restrict imports. It is not enough to point out that this is short-sighted or that freer trade since World War II has raised living standards for more people, in more countries, by larger amounts than in any previous period. That is unlikely to stop the pressure for new trade barriers.

At one time, I thought that China's surplus at a fixed exchange rate would inflate the currency and raise Chinese prices. Instead, depreciation of the dollar and a pegged exchange rate produced a depreciation of China's real exchange rate. Although China has experienced some inflation in the past two years, the combination of exchange controls and capital controls has hindered adjustment.

### ***What To Do?***

The studies cited earlier and many others suggest that taken separately revaluation of the renminbi, increases in a U.S. national saving rate, or other unilateral actions of reasonable size would not yield a permanent solution.

A multilateral solution should be developed. There is a need for policy coordination to obtain a solution that overcomes political blockage in each region and induces actions that are beneficial to each of the countries or regions. I side with those who believe a crisis is unlikely, but a prudent person should not ignore the risk posed by current imbalances and policies.

The component parts of a multilateral solution are well known. The United States has to increase its national saving rate. China and other Asian countries have to reform their financial sectors and allow exchange rates to adjust. Large European economies and Japan have to make structural changes that reduce unemployment and increase world demand. Those adjustments are beneficial in the long-run to the countries that make them. The problem is to overcome the political impediments to a solution that is of benefit to each of the participants but difficult to arrive at unilaterally. Hence there is a role for coordination.

I have no illusion that coordination can be achieved easily. The IMF and the BIS should accept responsibility for beginning negotiation. Negotiations may be slow to achieve agreement and, of course, they may fail. That is never a reason for not starting.

Under its rules, the IMF has responsibility for the exchange rate system and for preventing countries from using an undervalued exchange rate to promote domestic employment objectives. Current policies in many Asian countries surely call for more effort by the IMF to enforce this rule. On the other hand, Asian countries are surely correct when they claim that the U.S. national saving rate is a cause of imbalances. And U.S. policymakers are correct when they claim that slow growth in Europe and Japan are part of the problem. Each is correct. That's why a multilateral solution to put the world economy on a more stable path is both desirable and probably necessary.

The BIS has a smaller, but still significant role. Current imbalances are not solely monetary problems, although fixed Asian exchange rates are an important part of the problem. A main role of the BIS is to begin discussion by central bankers of a multilateral solution and to encourage central bankers to use their influence to get governments to reach agreement.

Let me close by mentioning a possible side effect of adjusting the renminbi to reflect its market value. China has used revenues provided by its rapid growth to finance a large armaments program. Unless the entire effect of slower growth would be borne by domestic consumption and productive investment, the military build up would slow. This would benefit Asia and the rest of the world.

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