

Global Imbalances and Policy Options *

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<Abstract>

Global imbalances are large and growing in the sense that the US current account deficit and, as a result, the US net foreign liabilities are increasing, while the current account surplus, as a result, foreign exchange reserves, of the rest of world, in particular, in the East Asian region, is increasing. As causes of the global imbalances, twin deficits, global savings glut, and exchange rate misalignments are pointed out. Naturally, the global imbalances lead to the fall in the US dollar and instability of the international monetary system.

In order to escape disorderly rebalancing with hard landing, it is essential to increase mutual understanding as to the real causes of global imbalances and to reach a consensus on how much the US will carry out structural changes to reduce investment-saving gap, and how much ROW having accumulated current account surplus will appreciate their currencies.

Key words: Global Imbalances, Current Account, Reserve Accumulation

JEL Classification: F31 F32 F33 F42 F59

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I. Introduction

Global imbalances are large and growing. US current account deficit are increasing to \$665 billion in 2004 and about \$792 billion in 2005, 6.3 % of GDP. On the other hand, the current account surplus of the rest of world is increasing. Their reserves, in particular, in East Asian region, began to be accumulated since the early 1990s as the capital market opened, and after the crisis, it again began to rise with the help of huge capital inflows and current account surplus. On the other hand, the US net foreign liabilities are growing to 25 % of GDP. It is expected to increase to over 50% by 2010 and towards 100 % of GDP by 2015.

In these regards, why such global imbalances are large and growing, what their effects on the global economy and the international monetary system are, whether such global imbalances are sustainable, and, if not, how to rebalance the global imbalances are currently becoming controversial issues in the global economy.

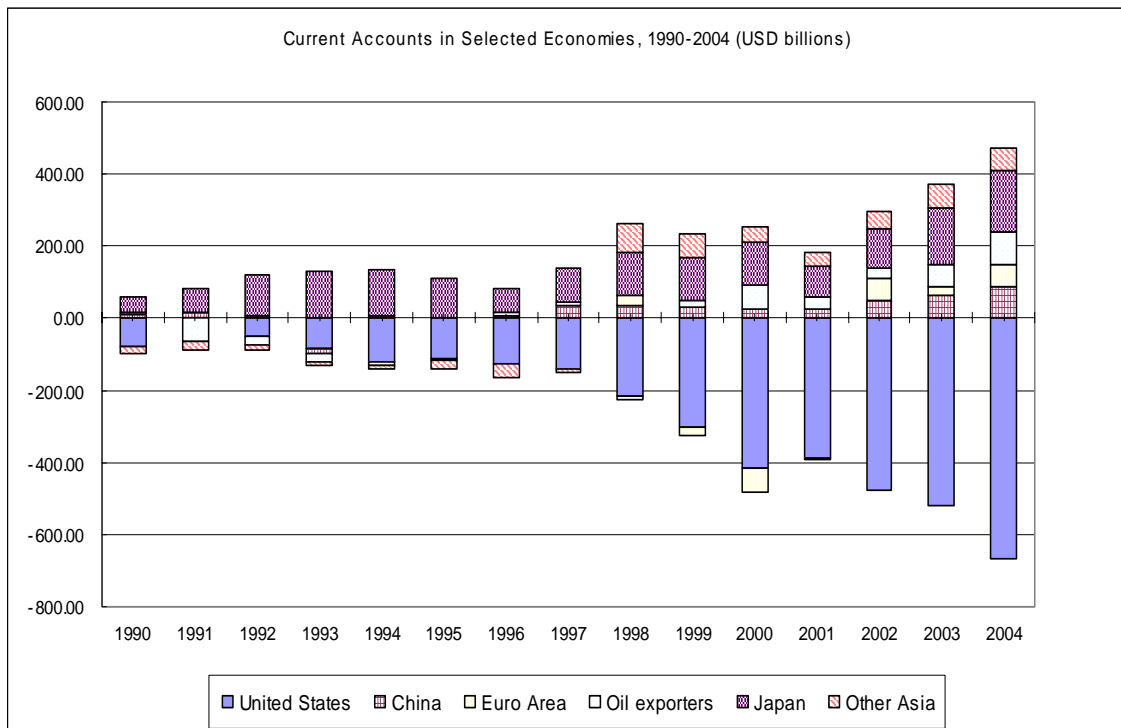
In the following Section II, the trend of global imbalances will be briefly outlined. The causes and consequences of global imbalances will be examined respectively in Sections III and IV. Finally, by way of conclusion, policy options to resolve the severe global imbalances and to avoid another global financial crisis will be explored in Section V.

II. Trend of Global Imbalances

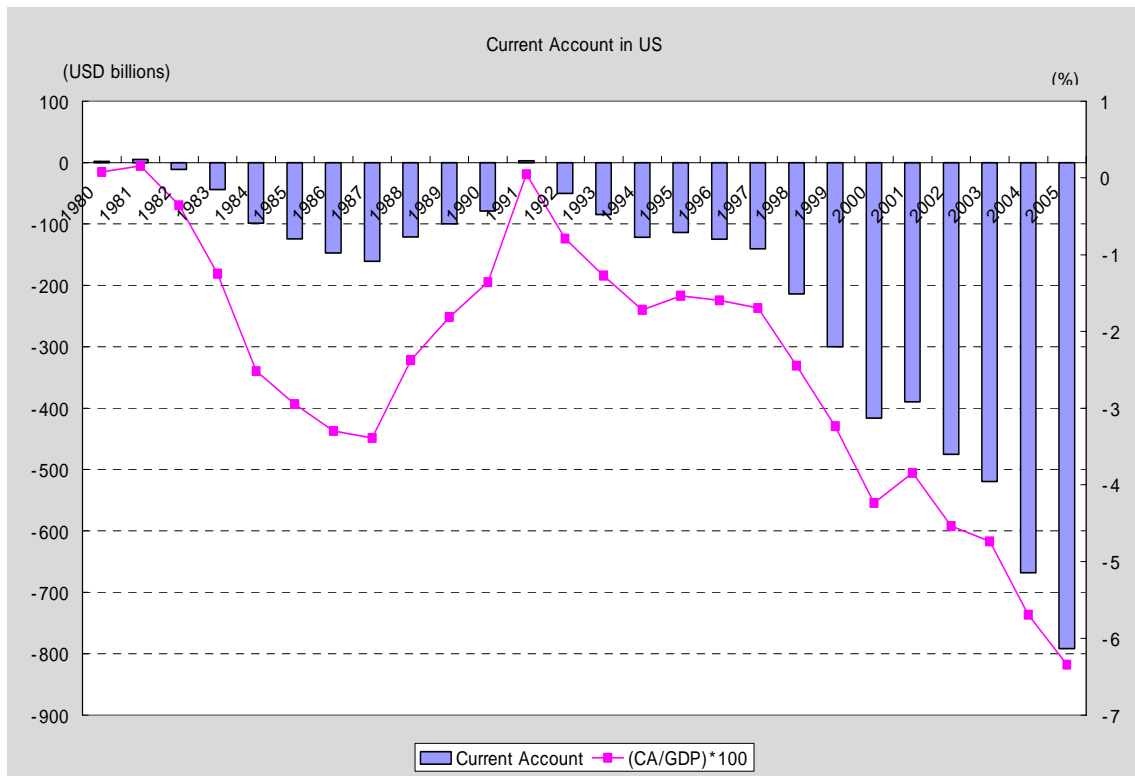
1. Current Account Imbalances

Global imbalances are large and growing. US current account deficit are increasing to \$665 billion in 2004 and about \$792 billion in 2005, 6.3 % of GDP. Moreover, it is expected to be growing further to reach 8~9% of GDP in the next few years. On the other hand, the current account surplus of the rest of world is increasing.

<Figure 1>



<Figure 2>



The US market occupation ratios in terms of the ratios of composition of US trade deficits by countries considerably changed. It increased from 30.4% in 1989 to 34.8% in 2004 in 7 East Asiaian countries including China Taiwan Korea Singapore Thailand Malaysia Indonesia. Among 7 East Asiaian countries, it substantially increased from 5.6% in 1989 to 24.9% in 2004 in China only in East Asia. All other East Asian countries experienced a decrease of the US market occupation ratio; from 5.7% to 3.0% in Korea, from 11.9% to 2.0% in Taiwan respectively during the same period. In particular, the ratio in Japan considerably decreased from 44.7% to 11.5%. Among East Asian countries, an only increase in China was achieved mainly with the help of his management of exchange rates in his favor against other East Asian counterparts (Oh, 2006a, 2004, 2001).

<Table 1>

US Trade Balances against Major Trading Partners

(USD billions, %)

	1989		1997		2004	
EU 15 Countries	1.0	(0.9)	16.7	(9.2)	104.5	(16.0)
(Germany)	8.0	(7.3)	18.6	(10.2)	45.9	(7.0)
Japan	49.0	(44.7)	55.7	(30.5)	75.2	(11.5)
Asia 7 Countries ²⁾	33.3	(30.4)	79.5	(43.5)	227.0	(34.8)
(China)	6.2	(5.6)	49.7	(27.2)	162.0	(24.9)
(Taiwan)	13.0	(11.9)	12.2	(6.7)	12.9	(2.0)
(Korea)	6.3	(5.7)	-1.9	(-1.0)	19.8	(3.0)
Middle & South America	9.2	(8.4)	6.4	(3.5)	84.1	(12.9)
Middle East Oil Exporters	4.3	(3.9)	-0.2	(-0.1)	22.1	(3.4)
Others	12.8	(11.7)	24.5	(13.4)	138.7	(21.3)
(Canada)	9.9	(9.1)	17.9	(9.8)	66.8	(10.3)
Total	109.6	(100.0)	182.6	(100.0)	651.7	(100.0)

Note: 1) Minus shows surplus of the US

2) China Taiwan Korea Singapore Thailand Malaysia Indonesia

Source: US Ministry of Trade

2. External Asset Position Imbalances

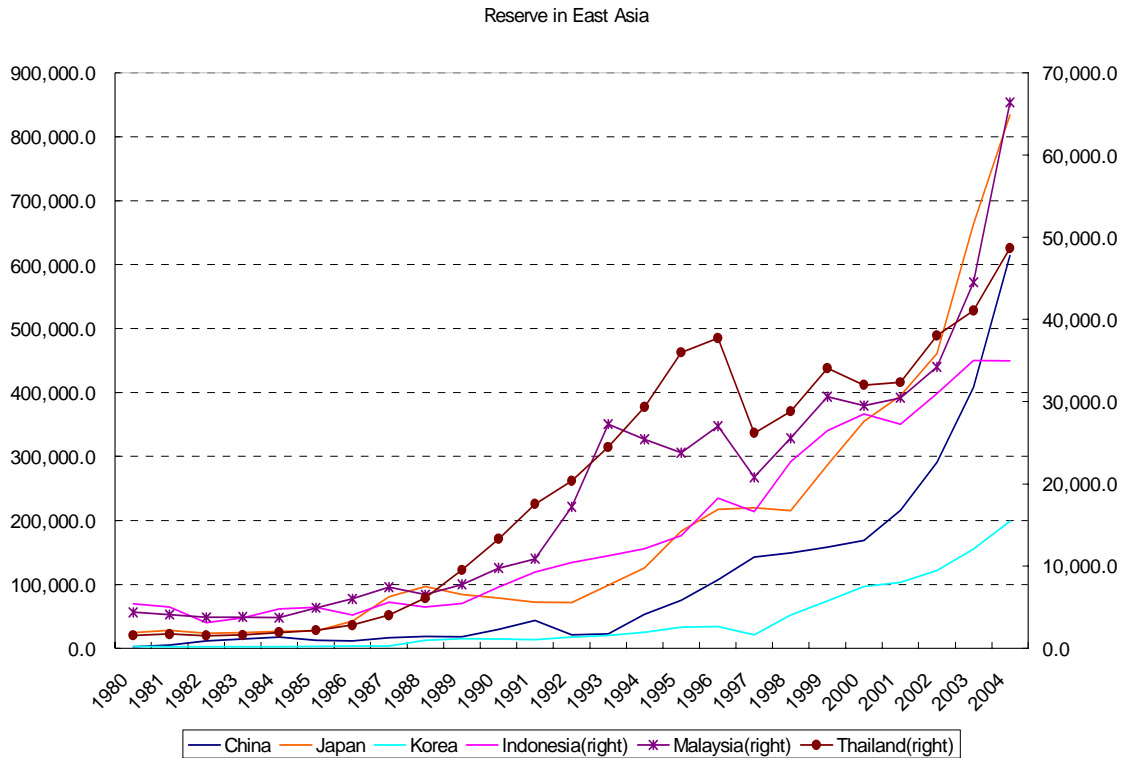
Until 1980s, the amount of reserves maintained at a low level in East Asia except Japan. Their reserves began to be accumulated since the early 1990s as the capital market opened, and after the crisis, it again began to rise. Why had not reserves been accumulated in spite of export-oriented economic policies before the capital market was opened in the early 1990s?

It is, in general, very rare for a developing economy to perform the current account surplus with only export-oriented policy until its development stage reaches a certain one having sufficient non-price competitiveness because its exports induce imports of intermediate and capital goods. Even it is in recent post-crisis years that East Asia began to perform stable current account surplus. The ratio of the current account surplus to GDP in recent East Asia shows 3-4 percents except Malaysia. In that sense, it may not be correct to point out that recent reserve accumulation attributed to mercantilist export-oriented policy.

Reserve accumulation in the 1990s before the crisis mainly resulted from the capital account surplus in spite of the current account deficit. Before the crisis, among capital inflows, overseas borrowing, in particular, short-term borrowing, increased with the help of the interest rate spread between low foreign and high domestic interest rates. Some of them are trade credits resulted from the current account deficits. Therefore debts, in particular, short-term debts increased, which resulted from overseas borrowing. Overborrowing became an issue (McKinnon and Pill, 1998). As a result, debt structure also worsened, which became a cause of crisis.

But, after the crisis, the structure of international capital flows have been significantly changed. High portfolio investments, in particular, equity investments, with the help of worldwide low interest rate and abundant liquidity and totally opened East Asian capital markets, increased in East Asian countries with expectations on high investment return composed of expected stock return plus expected appreciation rate of local currency. In China, high FDIs flow in also with expectations on high investment return composed of expected profit rate plus expected appreciation rate of local currency (Oh, 2006b, 2003).

<Figure 3>



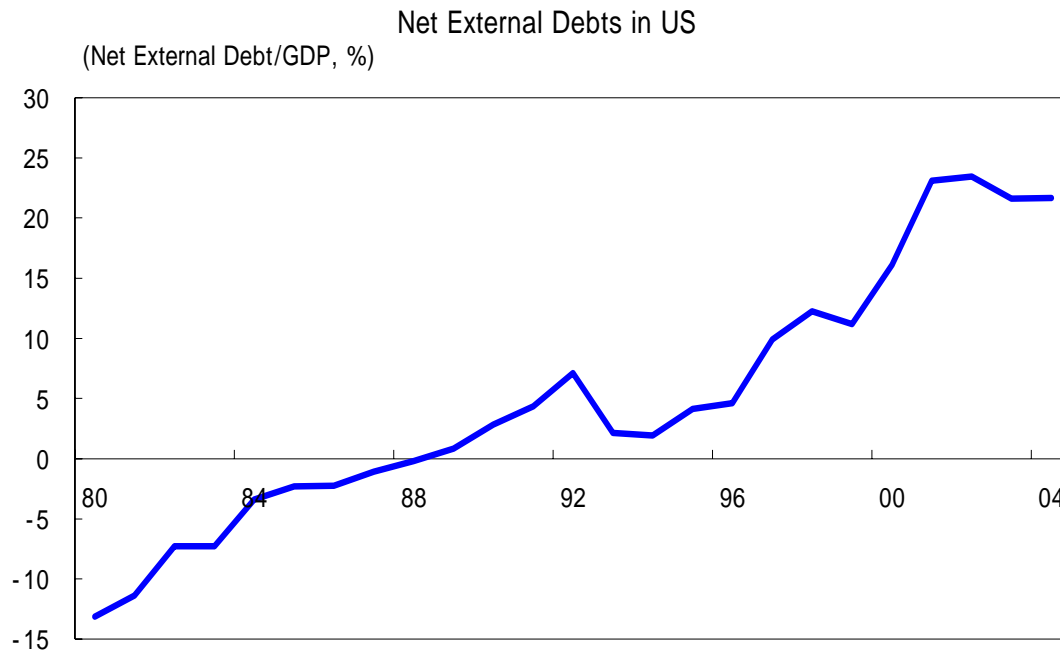
An increase in the current account deficit results in an increase in external debts. As the following identity shows, a change in net foreign assets (NFAs) is equal to the current account. A deterioration of the current account means a decrease in the stock of NFAs. The current account deficit has to be financed by a decrease in the foreign exchange reserves or an increase in foreign liabilities. If NFA is negative, i.e. foreign liabilities are larger than foreign assets, these are external debts.

$$NFA_{t+1} \equiv NFA_t + CA_t \qquad CA_t \equiv NFA_{t+1} - NFA_t$$

Accordingly, an increase in the current account deficit results in a huge increase in external debts and a substantial depletion of foreign exchange reserves in the US.

The US net foreign liabilities may be growing from 25 % of GDP now to over 50% by 2010 and towards 100 % of GDP by 2015. This is not sustainable as foreign investors will not be willing to pile up US dollars assets at these rates in their portfolio at unchanged US interest rate or dollar value (Roubini, 2006).

<Figure 4>



III. Causes of Global Imbalances

1. Twin Deficits

As in the following national income identity, the current account ($CA \equiv (X-M)$) in the external sector is identical to the amount of saving less investment in the internal sector. Accordingly, a current account deficit ($\Delta CA \equiv \Delta (X-M)$) means that, in principal, saving is less than investment in the internal sector.

$$Y \equiv C + I + (G - T) + X - M \qquad Y - C - I - (G - T) = X - M$$

$$S (\equiv Y - C - (G - T)) - I \equiv X - M$$

Suppose that consumption and investment are stable in the short run as often seen in a normal economy. In such a case, the fiscal balance is an important factor determining the amount of saving and, as a result, the amount of the current account ($CA \equiv (X-M)$) in the external sector. When the fiscal account is in deficit, the current account may also

record a deficit. These are what are termed the twin deficits.

Twin deficits began to appear from 1982 in the USA since the fiscal deficit began to widen due to the implementation of the so-called supply side economic policy based on tax cuts (otherwise known as Reaganomics) and the heavy military spending of the Reagan administration (1981-1988). The ratio of the fiscal deficit to GDP substantially increased from its previous 1-2 percent level to the 4-5 percent level. As a result, the current account shifted into deficit in 1982 and continuously worsened. Thereafter the current account was further deteriorated as a result of the first Reagan administration's strong dollar policy pursued in spite of twin deficits. These twin deficits persisted until 1988.

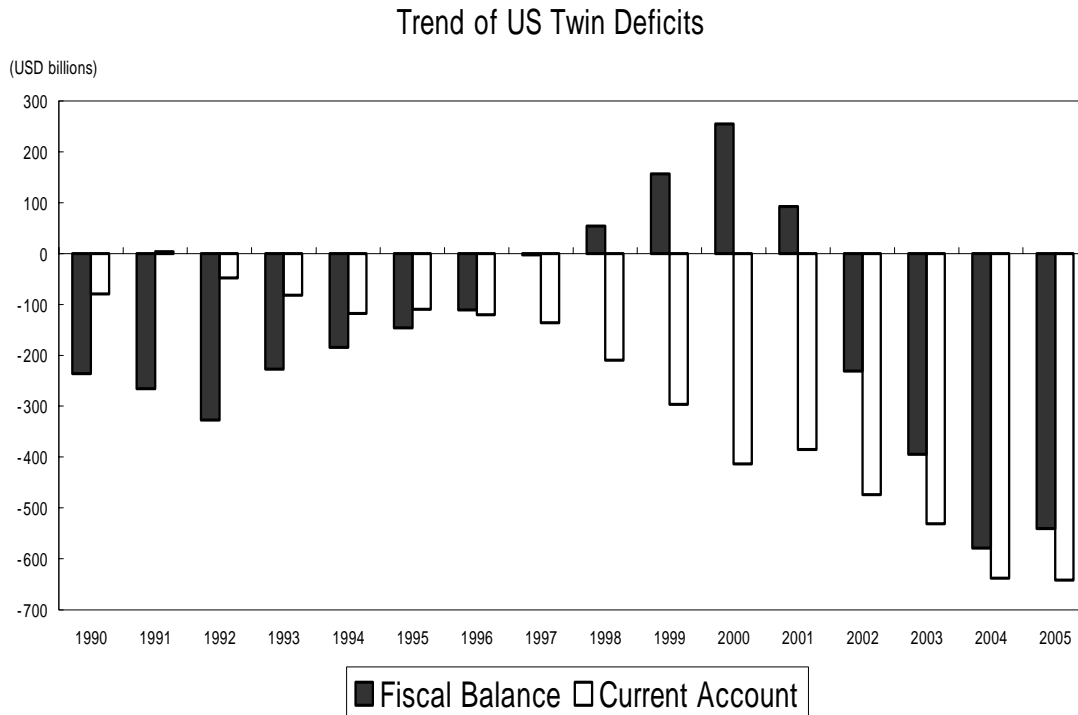
However, these twin deficits turned into "twin divergence" after 1989. The "twin divergence" means that the two accounts went in the opposite directions. In 1989 the fiscal deficit, after showing a slight improvement for a time, began to worsen again, while the current account deficit, which had shown a persistent deterioration until then, began to improve. After that, the US current account showed a sustained deficit and the fiscal balance also mostly ran a deficit except for four years from 1998 to 2001 when it benefited from the Clinton administration's (1993-2000) efforts for the fiscal rectitude.

Strikingly, during the Clinton administration period, the fiscal balance showed sustained improvement. Nevertheless, the current account position worsened continuously mainly because of a substantial increase in imports centering on IT goods as a result of the unprecedented decade-long high growth of the 1990s. As a result, both balances developed in opposite directions until 2001.

However, the fiscal balance again began to worsen from 2001 when the Bush administration was inaugurated, moving back into deficit in 2002, since then it has worsened. The current account deficit has also widened. This means that the twin deficits have again appeared since 2002.

In short, except for the single year of 1991, the current account has sustained a deficit, since it moved into the red in 1982, and eventually in 2004 the scale of the deficit marked a historical high of more than 5 percent of GDP. This external deficit mostly coincided with the fiscal deficit except in the late 1990s under Clinton. In the late 1990s, the dot-com investments boom in IT industries that had driven the unprecedented decade-long high growth in the 1990s also resulted in a current account deficit.

<Figure 5>



Source: IFS, IMF

2. Global Savings Glut

Bernanke has argued that the US current account deficit is not due to domestic factors but rather to a global savings glut. There is an excess of savings relative to investment in Asia, which leads to the current account surpluses in Asia. Accordingly, external, not domestic factors have caused the US current account deficit (Bernanke, 2005).

The story is as the following:

$$S^G - I^G + S^P - I^P \equiv X - M$$

$$CA^{US} + CA^{ROW} \equiv 0$$

$$CA^{US} \equiv (S^G - I^G + S^P - I^P)^{US}$$

$$CA^{ROW} \equiv (S^G - I^G + S^P - I^P)^{ROW}$$

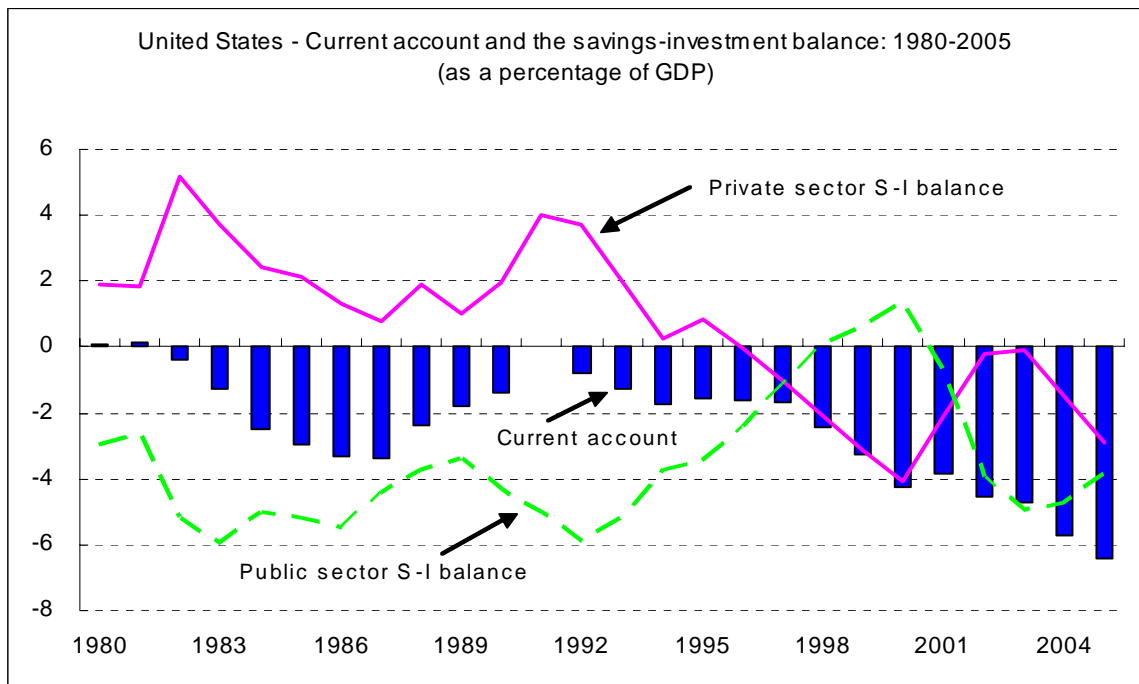
$$\text{Accordingly, } (S^G - I^G + S^P - I^P)^{US} \equiv (S^G - I^G + S^P - I^P)^{ROW}$$

S^G : government saving S^P : private saving
 I^G : government investment I^P : private domestic investment
 CA^{US} : Current Account in the US
 CA^{ROW} : Current Account in the Rest of World

In these identities, an exogeneous increase in ROW savings will lead to a reduction in global interest rates. The reduction in global interest rates will lead to an increase in the US investment and a reduction on the US savings that will cause a current account deficit.

However, in 2001-2003, investment fell and most of the fall in savings was due to a fall in public, not private savings in the US. Accordingly, in 2001-2003, the US current account deficit was caused by domestic, not external factors. But in 2004-2005, the US current account deficit has worsened in spite of no further worsening of the fiscal deficit since investment has started to pick up and private savings are falling.

<Figure 6>



Source: US Bureau of Economic Analysis, IFS IMF

<Table 2>

Saving-Investment Gap and Fiscal Deficit

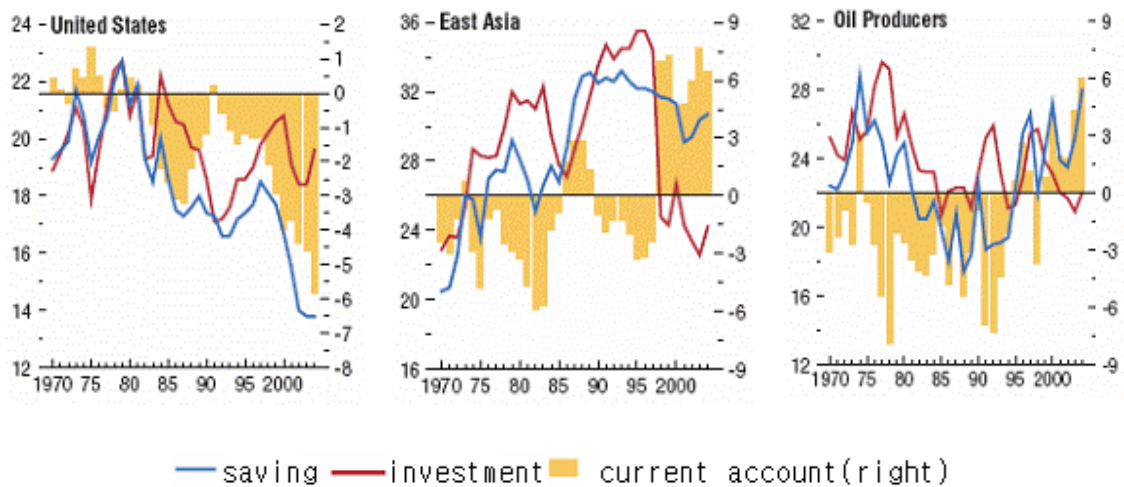
(%)

	1985	1990	1995	2000	2002	2004	2005
Total saving rate (A)	18.1	16.3	16.2	17.7	14.2	13.4	13.5
(Personal saving rate)	9.0	7.0	4.6	2.3	2.4	1.8	-0.4
Total Domestic investment rate (B)	21.2	18.6	18.6	20.8	18.4	19.6	20.1
A - B	-3.1	-2.3	-2.4	-3.1	-4.2	-6.2	-6.6
Fiscal balance /GDP	-5.0	-3.8	-2.2	2.4	-1.5	-3.5	-2.5

Accordingly, a savings glut in the ROW is contributing to keeping global interest rates low and allowing the US current account deficit to widen (Roubini, 2006). Low global interest rates may be due to excesss global savings or lack of investment in the world in the ROW. Investment rates fell in East Asia after the 1997 crisis, and investment in Japan and Europe was low because of low growth. In this sense, investment drought is more likely than savings glut (Roubini, 2006). On the other hand, investment boom resulting in higher growth relative to other advanced countries, but a decline in saving rate in the US in the 1990s led to the US current account deficit.

<Figure 7>

Saving and Investment Gap and Current Account in Selected Economies
(as a percentage of GDP)



Source: IMF

<Table 3>

Growth Rates in Selected Advanced Countries (%)

	1987~1996	1997~2005
Averages in Advanced Countries	3.0	2.7
■ USA	2.9	3.3
■ UK	2.4	2.8
■ Germany	2.6	1.3
■ France	1.9	2.2
■ Japan	3.2	1.1

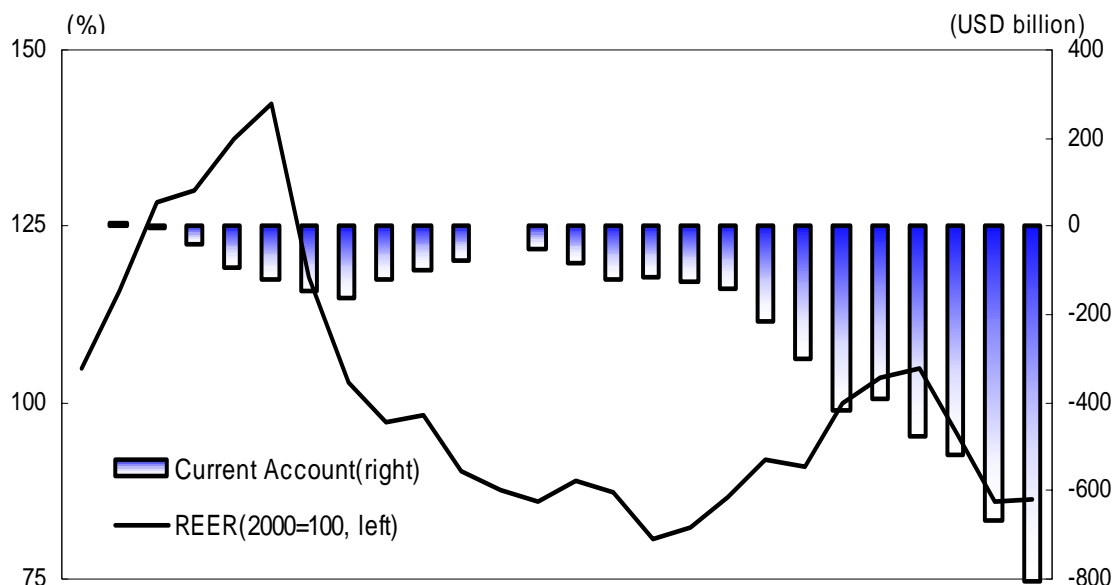
Source: IMF

3. Exchange Rate Misalignments

Usually periods of dollar appreciation are associated with worsening trade balance as in the periods from 1980 to 1985 and from 1995 to 2002, while usually periods of dollar depreciation are associated with improving trade balance as in the periods from 1986 to 1990. This implies that the dollar seems to need to fall more to improve the US current account deficit.

However, the dollar started to fall from 2002 and to 2004, but the US current account was worsening. Why was it worsening? During the period from 2002 and to 2004, the fiscal deficit grew and the consumption boom, mainly driven by housing, led to fall in private savings. This shows that dollar appreciation was not a sole cause of the US current account deficit, and dollar depreciation will not enough to adjust the US current account deficit. An improvement of the US current account deficit via fiscal deficit reduction means that the current account can improve without crowding out consumption or investment (Roubini, 2006).

<Figure 8> Exchange Rate and Current Account

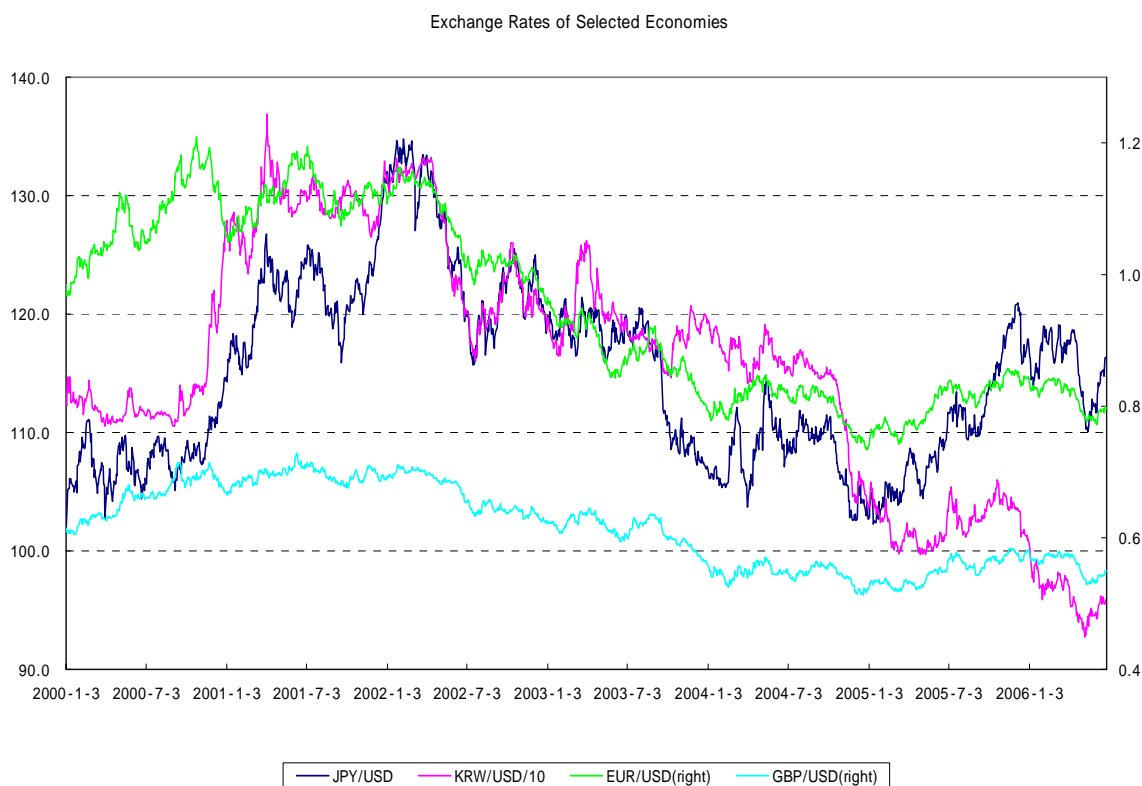


IV. Consequences of Global Imbalances

1. Weakening US Dollar and Unstable International Monetary System

The US dollar has rapidly declined again since mid-October 2004. As a result, for 2004 as a whole, it depreciated 7.6 percent against the euro and 7.5 percent against the UK pound. It also depreciated against East Asian currencies as well, i.e., 4.3 percent against the Japanese yen and 15.2 percent against the Korean won in 2004. In fact, the dollar began to weaken against major currencies from the beginning of 2002. It depreciated 52.4 percent against the euro, 31.9 percent against the pound, 28.1 percent against the yen, and 26.9 percent against the won during the three-year period from 2002 to 2004.

<Figure 9>



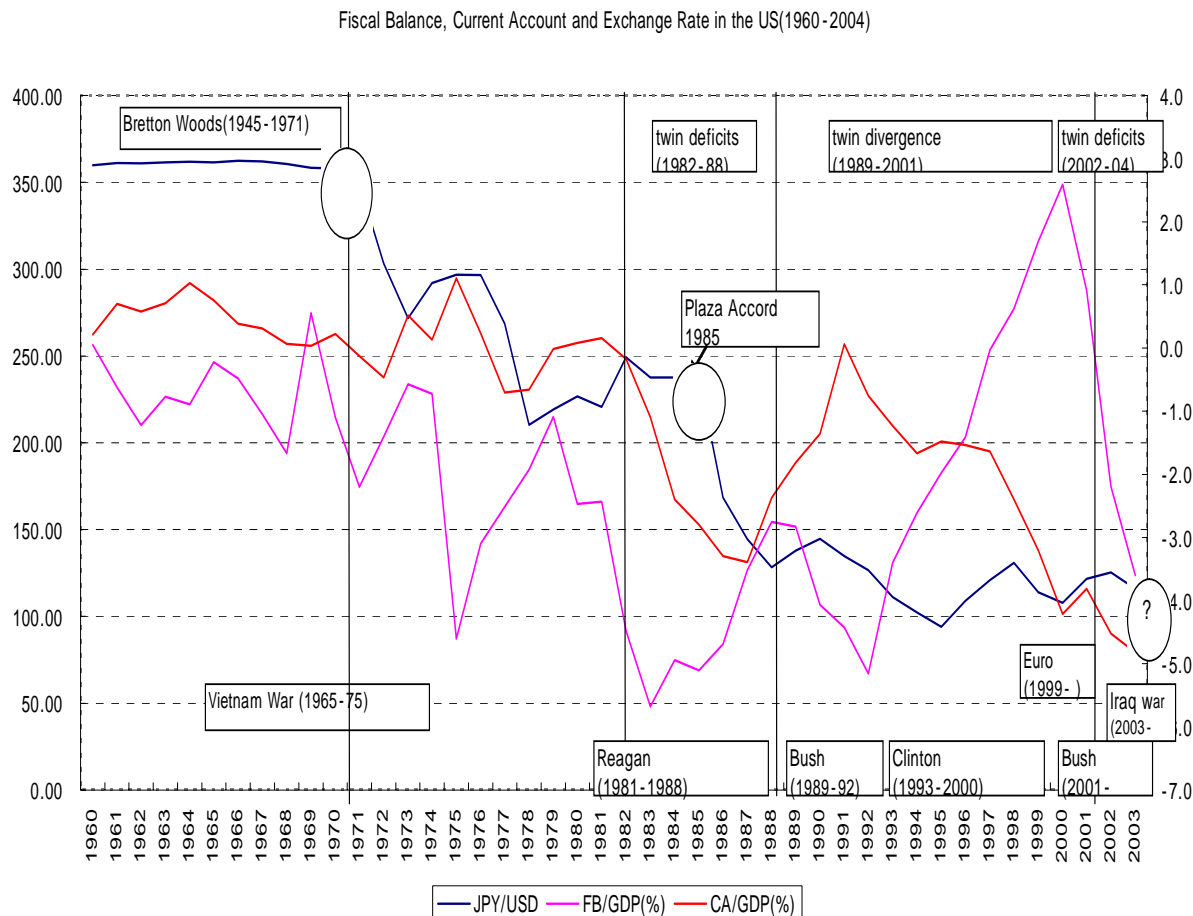
In the other channel, the exchange rate policy authority may introduce a depreciation policy to reverse the current account deficit. Market expectations of such a policy may also lead to depreciation to overshoot.

After the breakdown of the Bretton Woods system in August 15, 1971, the US dollar showed a continuous underlying depreciation over the long term. Finally, the G7 agreed on what was called the Plaza Accord to engineer a dramatic depreciation of the US dollar, in particular, against the Japanese yen in September 1985 after the US current account deficit registered US\$118 billion (2.8 percent of GDP), exceeding the US\$100 billion mark for the first time in US history.

Since 2002, the US current account has again worsened. In 2003 it stood out 531 billion dollars, topping US\$500 billion for the first time. In 2004 it is estimated to have worsened further reaching more than 5 percent of GDP for the first time in US history. Accordingly, the sustainability of the US current account deficit has become a hot issue. In a consequence, the market pressure for depreciation of the US dollar has increased, and, in addition, the news of the possibility of the US exchange rate policy authority tolerating a depreciation of the US dollar ahead of the US presidential election in

November 2004 led to some overshooting in the market. Eventually the US dollar duly slipped down rapidly from mid-October 2004.

<Figure 10>



2. Recycling International Reserves to the US Markets

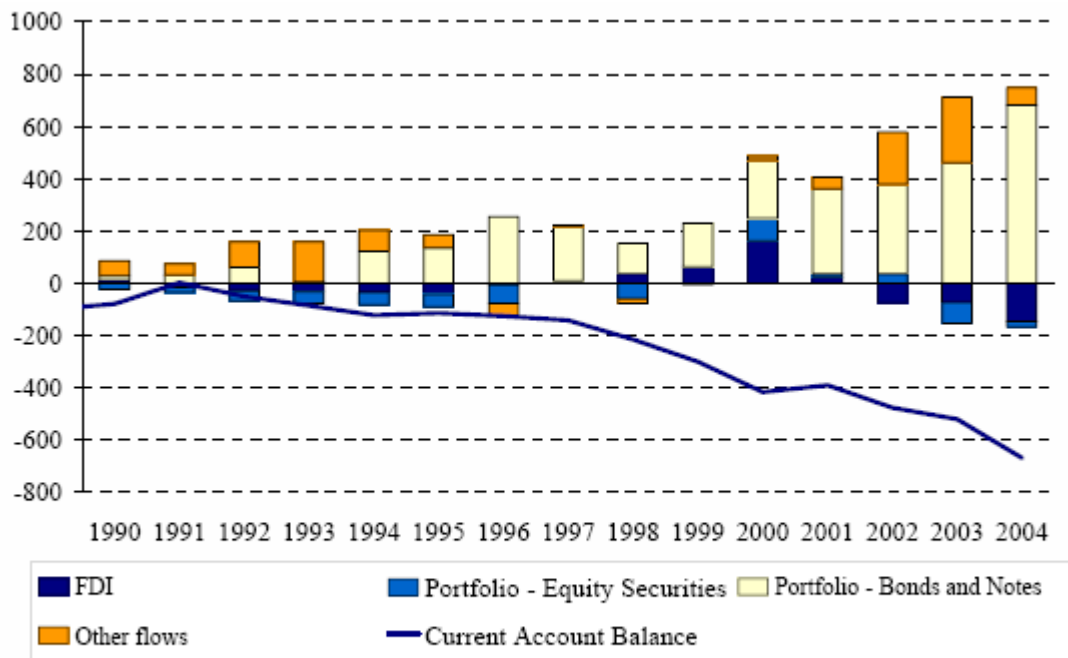
US current account deficit is being financed in dangerous ways. In the 1990s, most of inflows financing the deficit was private investors and net FDI or equity investment to the tune of US\$200 billion a year. However, in the 2000s, borrowing is being carried out in the form of debt, mostly government debt, the current account deficit is mostly due to a fall in public savings. Since 2003, net FDI has become negative investment to the tune of US\$200 billion a year. So debt financing of the current account deficit is greater than the current account deficit in 2004. The current account deficit of US\$665 billion, and equity or FDI of US\$200 billion in the capital account mean that the US had

to borrow in debt form to the tune of US\$885 billion.

In particular, most of borrowing is coming not from private investors, but from central banks of foreign countries having accumulated foreign exchange reserves. Therefore, private financing has shrunk while official financing is dominant. In 2004, US\$500 billion of the current account deficit of US\$665 billion was financed by central bank accumulating US Treasury bills and bonds.

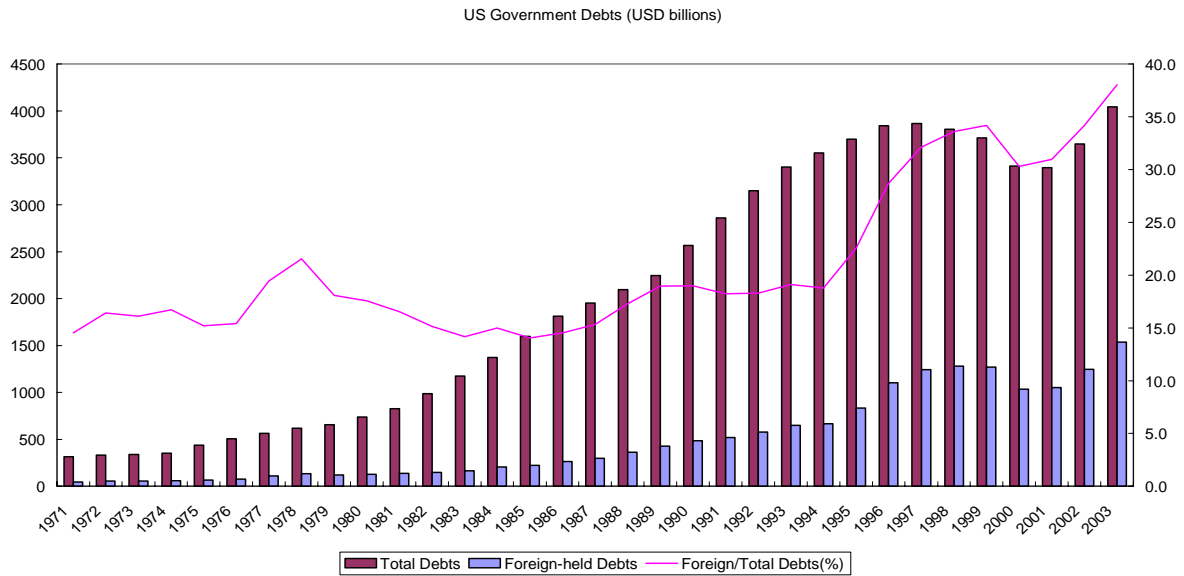
<Figure 11>

Financing of the US Current Account (USD billions)



Source: BIS.

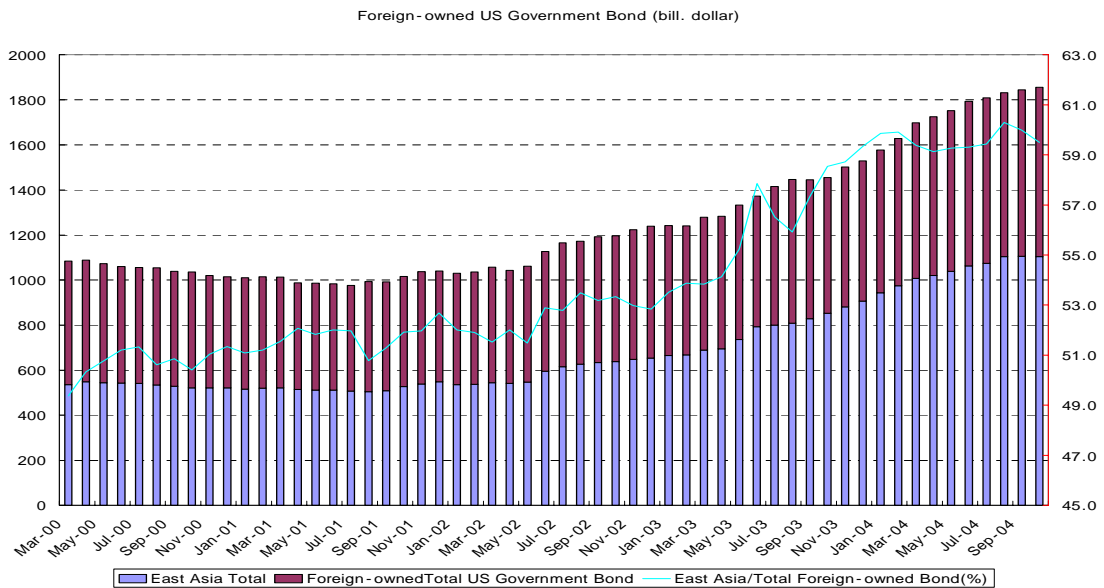
<Figure 12>



Since the 1980s, US government debt has increased substantially due to the sustained widening of the fiscal deficit in the US. Such debt reached US\$4043 in 2003. The ratio of foreign financing to total debts has also considerably increased, standing at 38 percent in 2003.

Foreign financing was mostly accomplished by issuance of government bonds. As of the end of October 2004, the amount of US bonds held by foreigners reached US\$1855 billion. Among them, the amount held by East Asian economies recorded US\$1104 billion, 59 percent of total foreign-held US government bonds.

<Figure 13>



Among East Asian countries, Japan held US\$715 billion, China US\$175 billion, Korea US\$66 billion, Taiwan US\$58 billion, Hong Kong US\$50 billion, Singapore US\$26 billion, and Thailand US\$15 billion as of the end of October 2004.

Such an increase in the current account deficit and external debts together with the depletion of foreign exchange reserves lead to an increase in the market pressure for depreciation. Expectations of depreciation, i.e., expectations of the possibility of exchange losses may lead to capital outflows, and thus the overshooting of the depreciation.

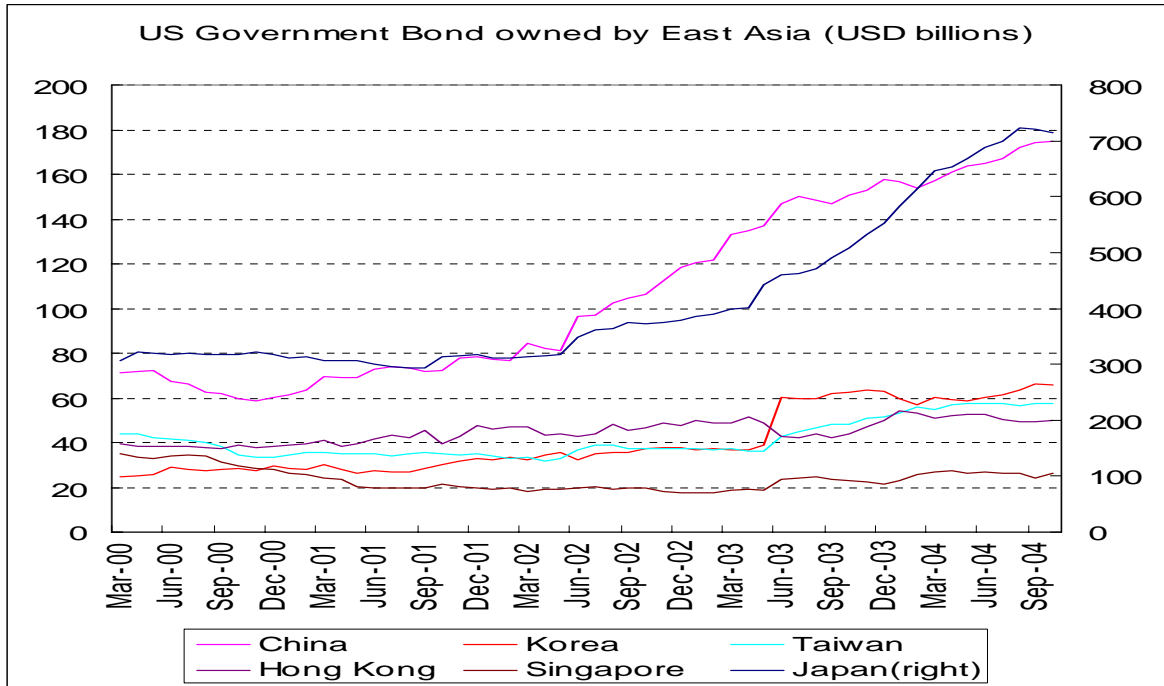
Taking into account this huge amount of US bonds held by foreigners, and in particular, by East Asian economies, expectation of a depreciation of US dollar may bring about a rise in fears of exchange loss, and as a consequence, may give rise to capital outflows from the US financial markets.

East Asia may be difficult to continuously supply the needed financing, since it is increasingly costly: First, cost of sterilized intervention is high, and the limit of sterilization may lead to excessive domestic credit growth and thus to asset and investment bubbles. Second, investment of growing reserves in low yielding dollar assets means growing risk of potential large valuation loss.

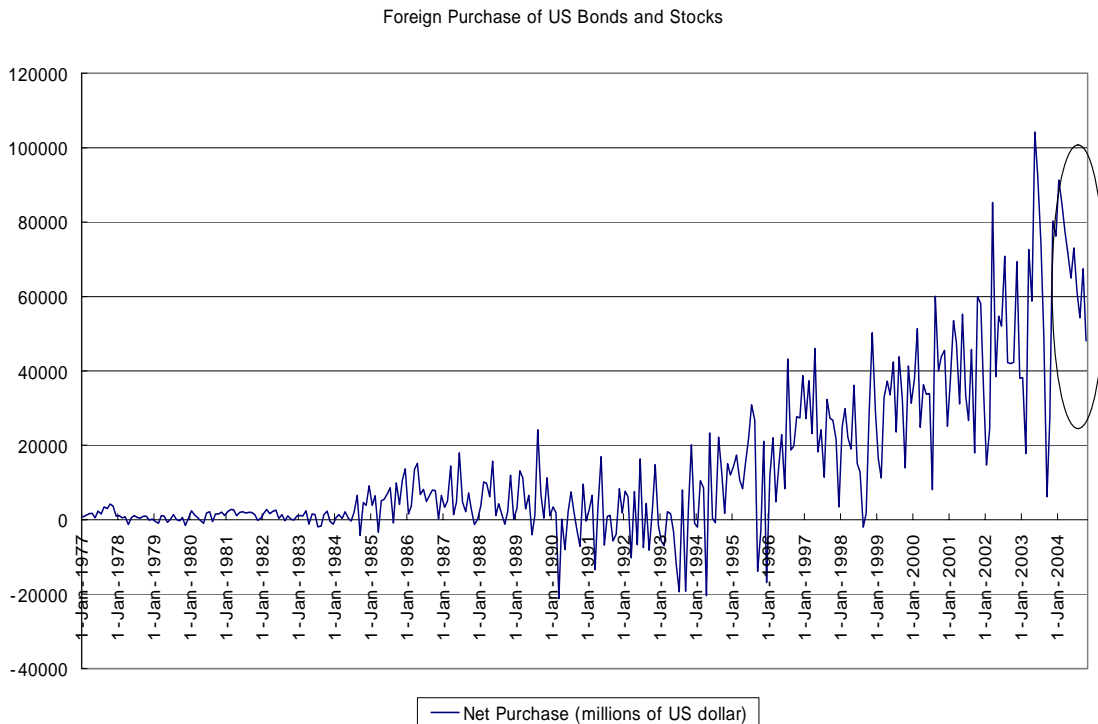
In the US perspective, since US foreign liabilities are in the dollar and US foreign assets are in foreign currencies, there is no negative balance sheet effect of dollar depreciation. In fact, US foreign debt falls when the dollar falls as the value of dollar-denominated debt stay the same while the value in the dollar of US foreign assets goes up. It is foreigners that hold dollar-denominated assets that bear the risk of a fall of the dollar. Their investments get a capital loss when converted into their local currency if the dollar falls. This is why the worsening of the US NFA position has been smaller than the US current account deficit in 2002-2004. The US had capital gains on our holdings of foreign assets while foreigners had capital losses on their holdings of US assets (Roubini, 2006).

In October 2004 when the dollar began to depreciate steeply, the amount of net foreign purchases of US bonds and stocks fell to US\$48.1 billion as against US\$67.5 billion in September 2004. In October 2004, most East Asian economies did not increase their US bond holdings in spite of a substantial increase in their foreign exchange holdings. Even Japan reduced its US bond holdings by US\$15 billion in October 2004. This means that most East Asian economies are trying to diversify their foreign exchange holdings into other currencies in order to hedge exchange rate risks.

<Figure 14>



<Figure 15>



Capital outflows may raise interest rates in the domestic financial market. In addition, the monetary authority may raise interest rates to contain inflation pressure due to depreciation. Accordingly, it may be assumed that expectations of depreciation

may cause a rise in interest rates through capital outflows in order to escape exchange loss and the tight monetary policy needed in order to contain inflationary pressures resulting from depreciation.

On the issue of whether an increase in the US interest rates due to depreciation of the dollar may lead to the instability of global financial markets, there may be some possibility of this happening unless appropriate countermeasures can be introduced at the global level.

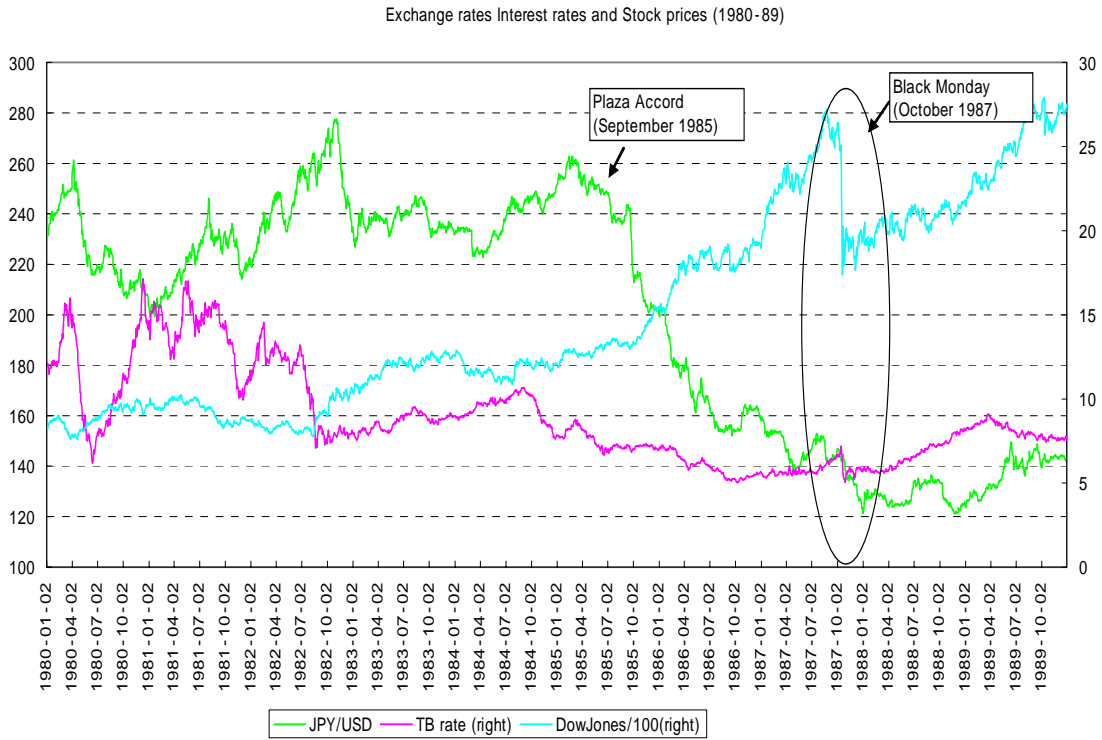
A rise in interest rates may spark a decrease in stock prices. In October 1987, there occurred the “Black Monday” stock market crash. The fall in stock prices in October 1987 was partly caused by the run-up in interest rates following the steep depreciation of the dollar after 1985 Plaza Accord. Needless to say, black Monday affected global financial markets through a contagion effect.

At the moment, an important issue is whether a rise in US interest rates following depreciation of the US dollar as well as capital outflows from the US stock market anticipating further dollar depreciation will bring about another black Monday stock market crash. The risk of a financial crisis is by no means negligible.

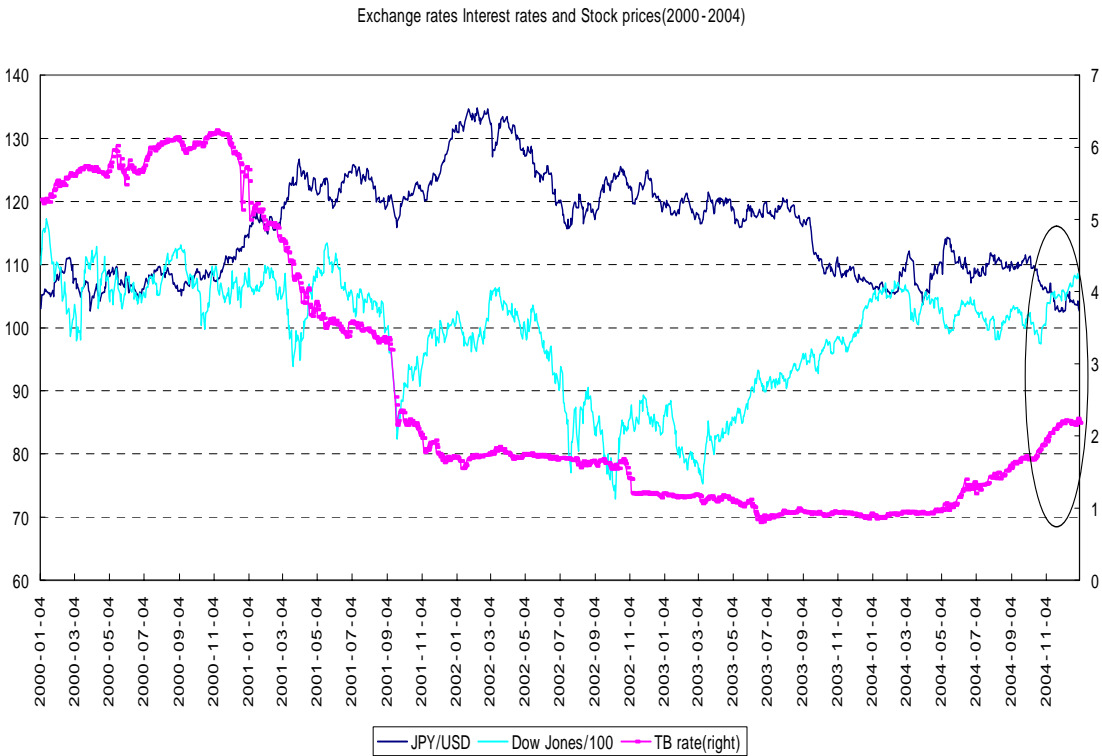
If such instability of global financial markets could not be prevented, the fall out in the financial markets could well be larger than from the crash in 1987 since the US current account deficit is now almost twice as large as it was in the mid-1980s in terms of its ratio to GDP (Economist, 2004a). The world economy would then be severely damaged due to an increase in the difficulty of direct financing.

The role of the US dollar as the key currency would be inevitably weakened, and an important change in the international monetary system might take place as well. Obstfeld and Rogoff see more parallels today with the dollar’s collapse in the 1970s in terms of large fiscal deficits, loose monetary policy and rising oil prices (2004).

<Figure 16>



<Figure 17>



V. Policy Options

It does not look easy to reach another Plaza Accord, mainly because the current international financial environment differs substantially from that of the mid-1980s in various aspects.

First of all, the economic situation of the target countries whose currencies should appreciate is very different. In the mid-1980s, the main target country was Japan, then enjoying a huge current account surplus. At that time, Japan could absorb shocks from the steep appreciation of yen with the help of the sustained huge surplus and its possession of high-level core technologies. In addition, Japan had already adopted a flexible exchange rate system.

Since 2002, the US current account has again worsened. In 2003 it stood out US\$531 billion, topping US\$500 billion for the first time. In 2004 it have worsened further reaching more than 5 percent of GDP for the first time in US history. Accordingly, the sustainability of the US current account deficit has become a hot issue. In a consequence, the market pressure for depreciation of the US dollar has increased, and, in addition, the news of the possibility of the US exchange rate policy authority tolerating a depreciation of the US dollar ahead of the US presidential election in November 2004 led to some overshooting in the market. Eventually the US dollar duly slipped down rapidly from mid-October 2004.

On the other hand, the current main target country is China, accounting for 23 percent of the US trade deficit in 2003 and with an increasing trend. In recent years, most other East Asian countries including Japan and Korea have shown a decreasing trend in their share of the US market occupation ratio with that of Japan registering 12 percent and that of Korea barely reaching 3 percent in 2004.

Nevertheless, Chinese internal economic conditions do not appear conducive to absorbing the shocks from a sizable appreciation of yuan in the short run mainly because of low-level technologies; high unemployment, particularly, in the rural areas; high nonperforming loan ratios in the financial sector and so on. In addition, the structure of the Chinese trade surplus also seems fragile because it is based, in principle, on imports of intermediate goods mostly from neighboring East Asian emerging economies and exports of assembled final goods, mostly to the US market. Notably too, China currently maintains a de facto fixed exchange rate system.

Moreover, the current Japanese economic situation is very different from that in the mid-1980s. At present, Japan is struggling to recover from a decade-long recession. The

US, at the moment, also seems to find it difficult to reduce its fiscal deficit mainly owing to the protracted Iraq war, which does not seem likely to come to an end in the short run, and to homeland security being strengthened since the terrorist attacks of September 11, 2001. In the mid-1980s, the USA was able to reduce its fiscal deficit from around 5 percent of GDP to 3 percent. Considering these international financial conditions, it would seem difficult to reach international coordination for a substantial depreciation of the US dollar as in the mid-1980s.

Taking into account the recent international financial market environment, the recent weakening of the US dollar seems structural rather than temporary or cyclical, and accordingly, the situation is not one that is easy to stabilize in the short run. Here one of the major obstacles is the considerable difference in interpretations of the causes of the huge US current account deficit of over 5 percent of GDP, the first on this scale in US history.

The US seems to think that the main cause of its huge current account deficit is the overvaluation of the US dollar, in particular, against East Asian currencies, while others argue that the US current account deficit reflects inadequate domestic saving. Without an increase in saving, even a big fall in the dollar would make only a small dent in US current account deficit (Obstfeld and Rogoff, 2004).

In fact, fiscal expenditures such as military and homeland security expenditures may be assumed to be less exchange rate elastic than private consumption and investment. In this case, a current account deficit resulted mainly from the exchange rate inelastic fiscal deficit rather than from exchange rate elastic private consumption and investment cannot be resolved simply with a change in the exchange rate without an accompanying reduction of the fiscal deficit itself. Of course, depreciation could also partly contribute to a decrease in the current account deficit through changes in domestic saving and investment resulted from changes in the prices of imports and exports.

If the fiscal balance is not improved, the possible way through which the current account deficit can be reduced would be through a fall in consumption, i. e., rise in private savings, and a fall in investment. But this way of adjustment, which would be triggered by an increase in interest rates, would be recessionary. Such hardlanding outcome would be bad for the US and the global economy.

How to rebalance the current global imbalances? There may be two scenarios to adjust the global imbalance: soft landing or orderly landing, and hard landing or disorderly landing: In the orderly landing, US fiscal restraint (expenditure reduction), exchange rate adjustment in China and East Asian countries combined with expansionary macroeconomic policies (expenditure switching), and acceleration of

structural reform in Japan and Europe to increase growth and imports (expenditure increase) are recommended (Roubini, 2006). Accordingly, reluctance of the US to reduce fiscal deficit, of East Asian countries to adjust exchange rates, and of EU and Japan to carry out reforms leads to low likelihood of orderly global rebalancing.

In such cases, disorderly rebalancing with hard landing for the US and global economy may take place. Sustained increases in the current account deficit and external debts in the US lead to an increase in the market pressure for depreciation of the US dollar. Expectations of depreciation, i.e., expectations of the possibility of exchange losses may lead to capital outflows, and thus the overshooting of the depreciation.

Capital outflows or a decline in foreign financing of the US twin deficits may raise interest rates in the domestic financial market. In addition, the monetary authority may be forced to raise interest rates to stem the US dollar fall and to contain inflation pressure due to depreciation. And then, an increase in the US interest rates may lead to the instability of global financial markets and to global economic slowdown.

Therefore, in order to escape disorderly rebalancing with hard landing, it is essential to increase mutual understanding as to the real causes of global imbalances and to reach a consensus on how much the US will carry out structural changes to reduce investment-saving gap, and how much ROW having accumulated current account surplus will appreciate their currencies. The US should try to reduce its fiscal deficit and to increase domestic saving, while countries with sizable current account surpluses, in particular, against the US, need to increase the flexibility of their exchange rate systems to escape a global financial crisis (Oh, 2005).

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