Flying on one engine
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America can no longer propel the global economy. Unless other countries take over, argues Zanny Minton Beddoes, the economic outlook is grim and globalisation is at risk

The evidence is still tentative, but America's economy seems to be gaining momentum. Consumers have stepped up their spending; the housing market is still sizzling; even manufacturing is perking up. For months, Wall Street's number-crunchers have predicted that America's real GDP growth will reach more than 4% in the second half of this year. That figure now looks more like a forecast and less like wishful thinking.

As the signs of an upturn accumulate, the relief abroad is palpable. From Mexico to Malaysia, the world is looking to America to lead a global economic rebound. In its latest projections, published on September 18th, the International Monetary Fund puts the growth in global GDP next year at 4.1%. But excessive reliance on America is also the biggest problem facing the global economy today. As Lawrence Summers, Treasury secretary under Bill Clinton, once put it: “The world economy is flying on one engine.”

The statistics are startling. Since 1995 almost 60% of the cumulative growth in world output has come from America, nearly twice America's share of world GDP (see chart 1). America's disproportionate contribution to global growth reflects an extraordinary rise in American spending. Domestic demand in America has risen, on average, by 3.7% a year since 1995, twice the pace of the rest of the rich world.
Just as flying on one engine is inherently risky, so a one-engined world economy is more likely to crash. Global prosperity depends overwhelmingly on American demand. If it were to drop significantly, the world would tumble into recession. Yet for years Americans have been spending far beyond their means.

America's national saving rate is at an all-time low. The country's current-account deficit—in effect, the amount it must borrow annually from foreigners to spend more than it produces—has been rising fast, and is now running at over 5% of GDP, a historic high (see chart 2). As a result, the United States, which as recently as 1980 was the world's biggest creditor country, has now become the world's biggest debtor country.

This survey will argue that the world cannot continue indefinitely to rely on American spending. The chances are that Americans themselves, weighed down by the burden of high debts, will eventually start to save more. But even if they do not, foreigners will become increasingly unwilling to fund American spending.

During the 1990s boom, it was American firms that powered the global economy with a huge debt-financed investment spree. But after the stockmarket crashed in 2000, investment spending collapsed as firms tried to strengthen their balance sheets. Total spending has kept going in part because American households have yet to make that adjustment. They, too, spent beyond their means during the 1990s bubble but carried on after the bubble burst, thanks to sharp cuts in interest rates that allowed them to borrow against their homes. American consumers' indebtedness is currently growing twice as fast as their incomes.

Increasingly, America's spending has also been fuelled by the government. The federal budget has shifted from a surplus of over 2% of GDP in 2000 to a deficit of over 4% of GDP this year. But even bigger budget deficits will not be able to compensate forever if private spending flags.

Moreover, borrowing from abroad at an accelerating rate can go on only for so long. Eventually the interest on the debt will become too onerous. Long before then, however, foreigners will become reluctant to provide the necessary capital. Already the share of America's current-account deficit that is funded by private foreign investors has fallen. It is Asia's central banks – mainly Japan's and China's—that are picking up an ever bigger share of the tab by buying huge quantities of American government bonds.

Their motivation is not altruistic. By piling into American bonds, Asia's central banks keep their currencies weak, supporting Asia's exports to America. But America's growing trade deficits are now causing protectionist pressures at home, particularly against China.

In the past three years almost 3m jobs have been lost in American manufacturing, one out of six in that sector. With a presidential election due in 2004, demands for action against China are multiplying. Either Asia's currencies will have to adjust, or America will retreat from free trade. On both political and economic grounds, it seems, the world's reliance on one engine is reaching its limit.
**Low on fuel**

But how can the world be weaned off its over-reliance on American spending without sending the global economy into recession? In theory, the route to a more balanced world is clear. Americans must spend less and/or foreigners must spend more and/or the dollar must fall (because a cheaper dollar shifts Americans' spending away from imports and boosts exports). Ideally, most of the adjustment should come from higher spending by foreigners. If other countries revved up their economies, they would suck in more American imports. That would allow America's current-account deficit to fall without causing the world economy to suffer.

It has been done before. In the early 1980s, when Ronald Reagan was president, America also borrowed furiously from foreigners, pushing up the current-account deficit to over 3% of GDP. In the later part of the decade, that deficit came down again without causing a global recession, thanks to a big but controlled drop in the dollar and especially to booming economies in Germany and Japan.

Can history repeat itself? If today's current-account deficit could be painlessly reduced, just as it was in the 1980s, the one-engined world might not be such a problem. But the chances of a repeat performance are slim. The imbalances are much bigger and more entrenched, and the world economy as a whole is both more fragile and more complex. There are no other obvious engines, and there is no easy way to get the dollar down.

Given their economic size, the euro zone, especially Germany, and Japan remain the most likely back-up motors for the global economy. But these economies are in a mess. Both regions are having to cope with a worrying combination of ageing populations (which tend to dampen spending) and structural rigidities (which slow down growth). In recent years, both have also suffered from extraordinarily incompetent macroeconomic policies.

Japan, the world's second-largest economy, has had an abysmal decade of deflation and stagnation, brought on by its government's inability to deal with the aftermath of its own asset bubble in the 1980s. In Europe, an obsession with tight macroeconomic policy has exacerbated the recent economic downturn.

There are some signs of change. In Germany, especially, there is now a recognition that the overtaxed and over-regulated economy has to be reformed. In Japan, the economy is perking up and there are glimmers of evidence that policymakers are at last grasping the need to reform. But both Europe and Japan have a long way to go before they can provide any back-up.

**A less mighty dollar**

With no alternative engines ready to kick in, the dollar will have to play an even more important role in America's adjustment than it did in the 1980s, when it fell by 55% against the D-mark and 56% against the yen. Since its peak in 2002, the dollar has already fallen by a total of 8% against its trading partners. But that is nowhere near enough.

Many economists reckon that, in the absence of a shift in global demand patterns, it would need to fall by 40% or more to make a serious dent in America's current-account deficit. That kind of depreciation is hugely risky. The more a currency falls, the greater the danger that it will fall too far, too fast. A sudden dollar crash could roil financial markets and plunge the world into recession.

Moreover, the dollar is unlikely to fall evenly against other currencies. The Asian central banks' determination to stop their currencies rising has, so far, concentrated the dollar's fall on the euro, with a
20% drop against the European currency since early 2002 compared with 8% overall. A further, even bigger drop in the dollar, targeted on the euro, would probably sink Europe's economies.

To spread the burden of a dollar drop more evenly, Asia's currencies too must appreciate. But that will not be easy either. In Japan—which has the world's biggest savings surplus and intervenes most actively to hold down its exchange rate—a dearer yen would lower import prices and further aggravate the economy's deflationary crisis.

Even in China, the case for a stronger yuan is not clear-cut. Unlike Japan, China is not running a big trade surplus. Its economy, despite rapid growth, is fragile; the banking system is bust. A sudden jump in the currency could cause the financial system to collapse, eliminating one of the few bright spots in the world economy.

With so many imbalances, and no easy adjustments in sight, the global economy is clearly in trouble. Stephen Roach, chief economist at Morgan Stanley (admittedly one of the most pessimistic seers on Wall Street), claims the world faces “its toughest array of macro problems since the end of the second world war”.

The risks of a dollar crash or a serious global recession are not insignificant, and a period of sluggish growth and currency volatility seems all too likely. The 1930s offer a lesson in how protectionism can flourish when economies are in recession and exchange rates tumble. For the past few years, politicians have done little more than hope that the American engine carries on working. But this is no longer good enough. Policymakers need to act to make a crash less likely and avert protectionist threats. A good first step would be to acknowledge the size of the problem.
The price of profligacy
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How bad is America's borrowing binge?

“I JUST think it's a meaningless concept.” That was the verdict of Paul O'Neill, George Bush's plain-spoken first Treasury secretary, on the current-account deficit. Mr O'Neill reckoned it was silly to worry about external imbalances in a global economy where capital flows freely. Foreigners, he argued, put their money into America because it offered the best risk-adjusted returns. A current-account deficit was merely the accounting consequence of these capital inflows.

Mr O'Neill was pushed out last December and Mr Bush's current economic team may put things less bluntly, but many of them are equally relaxed about the current-account deficit. Some acknowledge that, over time, the deficit may need to shrink, but reckon that in large liquid global capital markets, any adjustment will be gradual and benign. None of them appears to lose sleep over the sustainability of America's external account.

Are they right to be so complacent? The current account is a tricky concept that reflects several different balances at the same time (see article). From one angle, it is just the accounting counterpoint to capital inflows. Viewed from a different perspective, however, it is the sum of the trade deficit (showing how much more Americans import than they export), plus interest payments to foreigners on previous borrowing. In other words, it reflects how much Americans are borrowing to finance today's spending and to service yesterday's debt. If they are borrowing too much, the deficit becomes unsustainable.

Just as an individual cannot pile on credit-card debt forever, so a country cannot increase the burden of its foreign debt indefinitely. Eventually, interest on the accumulated debt would use up all the economy's resources, leaving nothing for domestic spending. In practice, however, the current-account deficit would have to adjust much earlier. Just when depends on a variety of indicators: the size of the accumulated debt; the rate at which new debt is piling up (the current-account deficit); the speed of economic growth; and the interest rate paid on the borrowed funds.

America's rate of borrowing is high and rising. At just over 5% of GDP, the current-account deficit is the highest in the country's history. Even in the final decades of the 19th century, after the Civil War, America's deficit was generally below 3% of GDP (though Canada and Argentina ran deficits as high as 10% of GDP in that period). In the Reagan era, the current-account deficit peaked at 3.4% of GDP.

Some of the recent rise may be a statistical quirk. According to official numbers, the world as a whole runs a current-account deficit with itself, and one that has risen sharply since 1997. Since the world does not, as yet, trade with Mars, the numbers must be wrong, so some of America's current-account deficit may be more apparent than real. But not all of the recent rise, or even most of it, can be explained this way.
In fact, America's current-account deficit is becoming worryingly large. Several studies suggest that economies hit trouble when their current-account deficits reach 4-5% of GDP. Caroline Freund, an economist now at the IMF and before that at the Federal Reserve, looked at 25 episodes of current-account adjustments in rich countries between 1980 and 1997 and found that the current account typically begins to reverse after the deficit has grown for about four years and reached 5% of GDP.

Another study at the IMF found only 12 episodes since 1973 where industrial countries have run a deficit of over 4% of GDP for more than three years in a row. All of the countries involved were relatively small and open economies.

Does it matter that America's current-account deficit is already an outlier by conventional benchmarks? Optimists claim not, pointing out that America has seen a big rise in productivity growth. That not only explains the higher borrowing (to fund the investment boom), but also makes it easier to finance the debt. There is something in that. America's productivity growth did rise sharply in the late 1990s, pushing the economy's trend rate of growth from about 2.5% to 3-3.5%. But the current-account deficit has increased far more rapidly. Worse, it is still rising, even though the investment boom is over.

**America is different**

Second, argue the sanguine, America has unique characteristics that allow it to run a larger deficit. It can borrow in its own currency, which also happens to be the global reserve currency. And it has the world's largest and most liquid stock and bond markets. Certainly these advantages allow America to borrow more than others. They reduce the risk of balance-of-payments crises of the sort that befall emerging markets, such as Argentina or Mexico, where no one is willing to lend them money at almost any price. But they do not remove all limits.

A better reason to take comfort is that the stock of debt is still relatively modest. America resembles a rich man who has discovered credit-card binging late in life. At the end of the 1970s, after decades of almost continuous current-account surpluses, the United States was a creditor country, with a net stock of foreign assets worth about 10% of GDP. Persistent current-account deficits turned the country into a net debtor in 1985, since when it has been getting deeper and deeper into the red. At the end of 2002, net external debt reached 25% of GDP (see chart 4).

That is higher than the debt levels at which some Latin American countries hit financial disaster in the 1980s debt crisis, and on a par with the peak debt level America reached in the 19th century, but it is not especially high by the standards of other rich countries. Many industrial nations have net foreign debts worth 40-50% of GDP. Australia's debt stock, for example, reached 60% of GDP in the mid-1990s, and Ireland's peaked at over 70% in the early 1980s. The trouble is that on current trends, America's debt stock looks set to rise sharply. If the current-account deficit remains at 5% of GDP, and the economy grows by 5% in nominal terms (roughly its trend rate of real growth plus inflation of just under 2%), America's debt stock will reach 40% of GDP by 2007 and 60% in a decade (see chart 5).
The bottom line

Can America afford this kind of indebtedness? That depends on the interest rate it must pay. So far, it has got away lightly. Until 2001, more income was generated by America's investments abroad than was paid out from the United States to foreign investors, even though the country became a net debtor in the mid-1980s. Even in 2002, America's net payments on foreign investments were less than $4 billion, a relative trifle.

No one is sure why America pays so little for its borrowing. One factor is the difference in returns on foreign direct investment. Americans have tended to earn higher returns on their FDI than foreigners have earned on direct investment in America. This may be due to different tax treatment, or to the age of the investment. American investments in foreign factories are usually older and generate a bigger stream of dividends than foreigners' more recent purchases in America. The difference in returns earned by foreigners and Americans on portfolio investment, in contrast, is much less marked.

More important, the returns—both to Americans and foreigners—have been falling. Wynne Godley, an economist at Britain's Cambridge university, in a paper published by the Levy Economics Institute of Bard College, in New York state, has calculated a crude "quasi-interest rate" earned on America's external financial assets and liabilities, by dividing the payments received [and made] in one year by the stock of assets [and liabilities] at the end of the previous year. For the past two decades, both rates of return have closely tracked the yields on Treasury bills (ie, fallen sharply). Last year this quasi-interest rate fell to just over 1%. Falling borrowing costs have, so far, masked the rising external debt.

That is unlikely to continue. In the years ahead, America faces a sharply rising debt stock and, quite probably, higher interest rates, so net interest payments to foreigners could become much more significant. If the average interest rate paid on external debt goes up to 3%, for instance, and the debt stock rises to 40% of GDP in 2007, as current trends suggest, Americans will be paying out close to $150 billion in interest, the equivalent of 1.2% of GDP. That would mark a huge increase from the current $4 billion, and could start to hurt.

Add all these factors together, and the trend in America's indebtedness will become unsustainable, but not for a while yet. More debt could be built up through a few more years of large and rising current-account deficits before the costs of borrowing start to have a dramatic effect on the economy.

But long before that happens, foreigners may become less willing to hold yet more American assets. Foreign investors' decisions are affected by two, sometimes conflicting, factors: the risk-adjusted returns that American assets offer, and the desire for a diversified portfolio. If American assets offer high returns, then investors may be prepared to buy more of them. But at some point the desire for a diversified portfolio will impose a limit.

Got enough greenbacks, thanks
Investors' recent behaviour suggests that foreigners' appetite for American assets may already be beginning to flag. In the past couple of years, the composition of capital inflows has changed significantly, and in a worrying direction. Private investors, who in the late 1990s were snapping up American shares, bonds and factories, more or less stopped buying anything but bonds in 2001. Foreign direct-investment flows, which reached a peak of 1.6% of GDP in 2000, have turned negative. And as purchases of American securities by private foreign investors have fallen, the current-account deficit has risen (see chart 6). According to Jim O'Neill, head of economic research at Goldman Sachs (and no relation to Paul), private portfolio flows and direct investment in the first three months of 2003 were worth only 1.4% of GDP. The remainder of the current-account deficit of 5.1% of GDP was funded by short-term speculative capital flows and official purchases of bonds by foreign central banks.

This lack of enthusiasm for American assets clearly shows up in the fall in the dollar since the beginning of 2002: to entice buyers, their relative price had to fall. Some of this drop may have been temporary, caused by low bond yields and a sluggish stockmarket. Indeed, as bond markets temporarily rallied in the second quarter of 2003, portfolio flows picked up. And as America's economic prospects have brightened in recent months, part of the dollar drop has been reversed. But there are also good reasons to believe that foreign investors have got enough dollar assets in their portfolios.

Every three months, The Economist asks a group of global portfolio investors about their asset allocation. The most recent figures show that American stocks make up 53% of the typical investor's equity portfolio and American-issued dollar bonds around 44% of the typical bond portfolio. Those proportions are slightly lower than at their peak in 2001, with 54% and 50% respectively. In the mid-1990s, in contrast, global investors allocated only around 30% of their assets to American dollar assets. In the late 1990s, therefore, the typical investor hugely increased the average share of American assets in his portfolio. In order to raise the average so quickly, the marginal investment in American assets must have shot up.

Catherine Mann, an economist at the Institute for International Economics in Washington, DC, who has pioneered the portfolio-based analysis of current-account sustainability, calculates that in 1998-2001 the typical investor allocated an average of 80% of his increased wealth to American assets. The question is whether this can continue. Ms Mann calculates that if the current-account deficit is to remain sustainable, foreigners will have to go on allocating 80-90% of their marginal investments to American assets over the next couple of years. That is not inconceivable, but it seems unlikely.

In sum, even if America could afford to take on more debt, foreign investors appear increasingly unwilling to hold it. True, foreign central banks, whose asset-allocation decisions are based on political as well as economic criteria, could continue to pick up an ever-increasing share of the burden. But, as a later section of this survey will show, central banks cannot underwrite America's current-account deficit indefinitely. The chances are that an adjustment is close. It will not be easy.
A quick guide to the balance of payments

JUST as a company's accounts can seem impenetrable to the layman, so a country's external accounts look intimidating at first sight. Like corporate accounts, they need decoding.

A country's balance of payments gives a snapshot of all transactions with foreigners. It has two main parts. The current account measures mainly trade in goods and services (known as the trade balance). It also includes interest paid on foreign borrowing (or received on foreign investments), as well as unilateral transfers abroad, such as official foreign aid and remittances by foreign workers.

The second part of the balance of payments is the capital account. It measures all asset transactions with foreigners. The private capital account is made up of private investments, whether foreign direct investment, stocks, bonds or bank loans. All official transactions (such as the central bank building up reserves) are dubbed “official reserve transactions”.

The sum of the current account, the private capital account and the official reserve transactions is always zero. Thus net capital inflows, whether private or official, imply a current-account deficit. Net capital outflows, in contrast, mean the current account will be in surplus.
But what do these balances mean in economic terms? A country that runs a current-account deficit is spending more than it produces, making up the difference by borrowing from abroad. Put another way, the current account is the difference between how much a country saves and how much it invests. A rising current-account deficit could imply rising investment or falling saving, or both.

To reduce a current-account deficit, a country must save more and/or invest less. Higher saving can come from the private sector (companies or households) or from the government through a smaller budget deficit.

The current-account balance shows the pace at which debt is being incurred (or, for a surplus country, the pace at which assets are being accumulated). The basic balance of payments (the current account plus long-term private capital inflows) gives a sense of how much a country is borrowing and how willing private investors are to fund that borrowing by providing long-term capital.
Shrink-proof
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Why America's deficit is hard to turn around

IF FOREIGNERS lose enthusiasm for American assets, they simply click on a mouse. Capital markets are the most liquid and efficient markets in the world; billions of dollars can shift at the touch of a button. The problem is that the other side of America's balance-of-payments ledger—the world of imports and exports—is much more sluggish.

According to economics textbooks, shrinking an external deficit should be straightforward enough. For the current-account deficit to shrink, the trade deficit must fall, which means that America must import less and export more. That, in turn, means raising foreigners' appetite for American goods and services relative to Americans' own demand for them.

There are two main routes. Either overall spending by foreigners rises relative to American spending as other economies perk up, or (more painfully) America's economy slows down. To help things along, Americans should shift their spending towards goods produced at home. A cheaper dollar will encourage them to do that while boosting American exports at the same time.

The most effective engine of adjustment would be an autonomous increase in demand abroad for American goods, perhaps through faster growth in customer countries. In practice, though, it tends not to happen that way. The typical current-account adjustment, according to the IMF study cited earlier, is associated both with a sizeable fall in the exchange rate and with a drop in output in the adjusting economy. Ms Freund's study for the Federal Reserve reached the same conclusion, suggesting that a sustained export surge is the most important factor in turning round a deficit.

Although America finds it easier than most countries to fund its external deficit by sucking in foreign capital, its economy has a number of characteristics that make it much tougher than elsewhere to shrink that deficit. The first problem is the sheer size of it, and the huge gap between imports and exports (see chart 7). At just under $1.4 trillion in 2002, America's imports are worth almost 50% more than its exports ($974 billion). Closing the gap means exports have to grow much faster than imports. If imports were to increase by, say, 4% (about half their average growth rate since the mid-1990s, and consistent with modest economic growth in America), exports would have to rise by 11%, more than 1.5 times the average of the booming late 1990s, to reduce the trade deficit to $300 billion over two years.

Moreover, Americans have a particular penchant for imports. Back in 1969, two economists, Hendrik Houthakker and Stephen Magee, noticed an odd phenomenon: for any given rate of economic growth, America's imports tended to grow faster than those of other countries (and faster than America's exports). So if all countries were growing at the same speed, and exchange rates remained stable, America's trade deficit would worsen inexorably. To stop the deterioration, the American economy would have to grow more slowly than others, or the dollar would have to fall.

This phenomenon has long perplexed economists. Why should America
be more addicted to imports than other countries? For a long time, economists thought it must have something to do with trade barriers abroad that prevented American exports from flourishing. But trade barriers, at least in the rich world, have been lowered substantially since the 1960s.

Another theory, pioneered by Paul Krugman in the late 1980s, is that Americans' apparent love of imports reflects the growing array of products made by countries that export to America. For any given rise in income, America's import demand is not abnormally high, he argued. Rather, it is the supply of exports from fast-growing supplier regions, such as East Asia, that has been rising.

Another explanation points to the high levels of immigration into America. Immigrants, goes the argument, have a particular penchant for goods from their own country. Thus imports in a country with lots of immigrants will be relatively higher than elsewhere.

Lastly, there is the possibility that the relationship between growth and imports shifts as economies develop. Catherine Mann, from the Institute for International Economics, finds that the predilection for imports is much less pronounced in services than in goods. That suggests America's import bias will become less marked as the share of services in the global economy becomes ever larger.

For the moment, however, the import bias remains. In a detailed re-estimation of the statistics in 2000, three economists at the Federal Reserve, Peter Hooper (now at Deutsche Bank), Karen Johnson and Jaime Marquez, found that America's imports rose 1.8% for every 1% increase in overall spending. A 1% rise in foreign demand, in contrast, produced a less than proportional (0.8%) rise in American exports.

This lopsidedness, together with the sheer scale of America's current-account deficit, means that tackling it will be tricky. Unless other countries grow substantially faster, relative to America, than they do now, the bulk of any adjustment will depend on a depreciation of the dollar.

Down with the dollar

Back in the world of economics textbooks, a fall in the exchange rate improves the trade balance in two stages. First, the cheaper dollar increases the relative price of Japanese cars, French wines and Italian holidays. Cars from Detroit, chardonnay from California or trips to Disney World, in contrast, become relatively less expensive. Second, this shift in relative prices encourages Americans to spend less on imports while boosting American exports.

In the real world, however, matters are more complicated. First, a drop in the exchange rate does not necessarily lead to an equivalent rise in the price of imported goods. This is partly because the final price of an imported good includes numerous costs, such as distribution and marketing, that are not affected by the exchange rate. Second, many countries that export to the United States (especially Asian ones) price their goods in dollars. Since these exporters are usually extremely keen to maintain their share in the world's biggest market, they often absorb the effect of a drop in the dollar by cutting their profits rather than raising the price.

Economists reckon that in the 1990s only about half of an exchange-rate change had worked its way through to manufacturing import prices after a year. Over a shorter period the effect can be even less. In the year to May, says Michael Rosenberg, chief currency strategist at Deutsche Bank, import prices to America, excluding oil, rose only 0.9%, even though the trade-weighted dollar fell by 6%.
But even if prices do move, spending patterns may remain much the same for a while, because consumers tend to be slow to adjust their spending in response to price changes. It also takes firms time to change orders and production levels. And even in the long run, the impact on imports of a drop in the dollar is weaker than that of a drop in income. According to calculations by Ms Johnson and Messrs Hooper and Marquez, a 1% drop in the dollar reduces Americans' demand for imports by only 0.3% in the long term. A 1% drop in income, on the other hand, reduces imports by 1.8%. So if a drop in the dollar is to make much of a dent in the trade deficit, it will have to be really big.

But just how big? The exact estimates differ, depending on how economists construct their models, but virtually all the numbers are startling. In perhaps the most optimistic analysis, Fred Bergsten of the Institute for International Economics reckons that the dollar needs to fall by another 15-20% on a trade-weighted basis to bring America's current-account deficit down to 3% of GDP. His calculation assumes some increase in relative demand from abroad. Failing that, the necessary currency adjustment becomes much bigger. Ken Rogoff, who is about to return to Harvard University after a two-year stint as chief economist at the IMF, and Maurice Obstfeld, an economist at the University of California at Berkeley, reckon it will take a fall of closer to 35% to get the current account back into balance. Mr O'Neill from Goldman Sachs is even more pessimistic, estimating that a trade-weighted drop of 43% will be needed to reduce the current-account deficit by 2% of GDP by 2007. And Mr Rosenberg of Deutsche Bank thinks that if demand patterns stay as they are, a depreciation of 40-50% may be called for to get the current-account deficit down to 3.5% of GDP.

These are enormous shifts. If the burden were spread equally across America's trading partners, a 50% drop in the dollar would send the euro to well over $2 and the yen to less than 60 per dollar. With exchange-rate changes of this magnitude, the risk is that currencies may move too fast and perhaps even too far. Historically, exchange rates have tended to overshoot. In the 1980s the dollar soared, then plummeted. In Mexico in 1995, the peso plunged and then recovered. In the 1997-98 Asian crisis, Indonesia's rupiah dropped by over 75% before gradually creeping back.

Even big exchange-rate shifts can be absorbed if they occur slowly. (The 8% drop in the dollar since early 2002, for instance, has not caused any problems.) But if they happen quickly, financial markets are roiled, and at worst financial institutions are unable to cope with the strain. LTCM, a hedge fund, collapsed when interest rates suddenly shifted after Russia's default in the summer of 1998. If the dollar suddenly plunged, similar problems could arise.

The risk of a dollar crash and a subsequent financial meltdown are not negligible. Discussing the coming fall in the dollar, Mr Rogoff recently commented: “The world is set to jump off the top of a waterfall without knowing how deep the water is below.”

Nonsense, say the optimists; just look at history. In the early 1980s, America's current-account deficit rose sharply. Policymakers, economists and journalists fretted about the prospect of a dollar crash. A book published in 1985, “Deficits and the Dollar”, by Stephen Marris, epitomised the mood. “On present policies a hard landing has become inevitable for the dollar and the world economy,” Mr Marris argued. “The dollar will, over time, go down too far and there will be an unpleasant world recession.”

The dollar did indeed go down, just as he had predicted, but there was no nasty recession. Can history repeat that feat?

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Reaganomics redux
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Why the world cannot count on a repeat of the 1980s

PARALLELS abound between Ronald Reagan and George Bush. Like the Gipper, Dubya is a sun-belt conservative with a fondness for his ranch. In all, Mr Reagan spent about one year of his eight-year presidency at his California retreat. Mr Bush has turned his patch of Texan scrub near Crawford into the hottest destination for world leaders.

In economic policy, the script, so far, seems eerily similar. Both presidents introduced huge tax cuts and big increases in defence spending. Mr Bush has already cut taxes by as much as Mr Reagan ever did, though he has not, as yet, matched the 1980s defence build-up. Both men spilled huge quantities of federal red ink. During Mr Reagan's first three years the budget deficit rose by 3% of GDP. Mr Bush has doubled that figure, presiding over a deterioration of 6% of GDP in the federal finances since 2000. And under both presidents external imbalances spiralled. During Mr Reagan's first four-year term, America went from a balanced current account to a deficit of almost 3% of GDP. Mr Bush inherited a current-account deficit of 4% of GDP. It is now over 5% and rising fast.

Critics of the current president make much of these Reagan-Bush parallels. They point out that it took a decade of painful budget discipline in the 1990s to work off the budget deficits built up in the profligate Reagan era. How comforting, then, that the Reagan-era story has a happy ending, at least as far as America's external accounts are concerned. Having soared in the early 1980s, the dollar started to fall from 1985. A couple of years later the current-account deficit began to reverse. By 1991 it had disappeared. Though there were nasty scares, notably the 1987 stockmarket crash, there was no global financial meltdown and no global recession.

However, today's world is very different. A brief detour back to the 1980s will show why.

Morning in America

The Reagan era, like the current Bush presidency, began with an economy in recession. But unlike the mild downturn of 2001, the 1981 version was severe, with soaring unemployment and plummeting output. The recovery, however, was quicker and more dramatic. Helped by big tax cuts, America boomed. In 1982-84, American domestic demand grew almost 15%, against less than 3% in Europe and 5% in Japan.

Unlike today, interest rates were high, so in 1980-84 the dollar rose by more than 80% against the currencies of its trading partners. The combination of a strong dollar and a strong economy sent America's trade deficit soaring. During Mr Reagan's first term, officials cared little about the strong dollar or the rising external imbalances. Like the current Bush team, they argued that a bigger external deficit simply reflected the attractiveness to outsiders of investing in America. The tone was defiant, even boastful. “In Europe they're calling it the American miracle,” Mr Reagan said in early 1985. “Day by day we are shattering accepted notions of what is possible.”
Within months, however, the mood in Washington had changed sharply. By the summer of 1985, the domestic political pressures from a strong dollar and rising trade deficit were becoming hard to contain. Congress was in a militant, protectionist mood. Japan was the scapegoat, blamed for hollowing out American manufacturing industry. Almost 100 trade bills were drawn up in 1985, each one of them protectionist.

James Baker, Mr Reagan's new Treasury secretary, realised that something had to be done to stem the protectionist tide. Over months of secret diplomacy, he put together a plan to secure international economic co-operation and currency intervention to push the dollar down. On September 22nd 1985, finance ministers from the world's five biggest economies—America, Japan, West Germany, France and Britain—announced the Plaza Accord at the eponymous New York hotel.

Each country made specific promises on economic policy: America pledged to cut the federal deficit, Japan promised a looser monetary policy and a range of financial-sector reforms, and Germany proposed tax cuts. All countries agreed to intervene in currency markets as necessary to get the dollar down. Perhaps not surprisingly, not all the promises were kept (least of all America's on deficit-cutting), but even so the plan turned out to be spectacularly successful. By the end of 1987, the dollar had fallen by 54% against both the D-mark and the yen from its peak in February 1985 (see chart 8).

**Keep it up**

This sharp drop led to a new fear: of an uncontrolled dollar plunge. So in 1987 another big international plan, the Louvre Accord, was hatched to stabilise the dollar. Again specific policy pledges were made (America to tighten fiscal policy, Japan to loosen monetary policy). Again the participants promised currency intervention if major currencies moved outside an agreed, but unpublished, set of ranges.

Heavy foreign-exchange market intervention in 1987 did stabilise the dollar. Meanwhile, America's external deficit began to shrink sharply, helped by the big depreciation but even more by relatively faster growth abroad. In the late 1980s, domestic demand slowed in America but remained strong in Germany and boomed in bubble-era Japan. By 1990 America's current-account deficit was down to 1% of GDP. A year later, after America's modest 1991 recession, it was in surplus.

The story of the Reagan era helps explain why the current Bush team is keeping so calm about America's external imbalances. Serious as they seemed at the time, the excesses of the mid-1980s were purged with relative ease. But behind the superficial similarities, America's situation now is quite different from that in the mid-1980s. The imbalances are bigger; the international economic environment is more complex; and America's trading partners are weaker. All these factors suggest that the adjustment will be riskier and more painful.

Start with the size of the problem. When Mr Reagan took office, America was still the world's biggest creditor. The current-account deficit at its peak in 1987 reached 3.4% of GDP. Mr Bush, in contrast, inherited an economy that was already the world's biggest debtor, and a current-account deficit that was already bigger than at its peak under Mr Reagan.

Besides, in the 1980s the current-account deficit had been rising for only four years before the Reagan team took action. It also had a clear cause: an investment boom after the 1981 recession, coupled with a collapse in saving as the budget deficit ballooned, which together pushed the dollar sky-high.

Today's deficit, in contrast, has been rising for over a decade. It was started by an investment boom in the mid-1990s; then fuelled by a dramatic drop in private savings as Americans splurged in the late 1990s; and
is now being sustained by a drop in public saving. An external imbalance that has gone on for so long, with so many disparate causes, is likely to be much harder to turn around.

Moreover, today's larger problem must be resolved in a global economic environment that is far more fragile than that of the mid-1980s. The world economy is still working through the aftermath of a huge asset-price and investment bubble. Inflation is much lower than it was in the mid-1980s. Deflation is already a reality in several countries, and hovers threateningly over many others. A drop in the dollar will put extra deflationary pressure on those countries whose currencies appreciate against it.

**No appetite for action**

Despite the world economy's greater fragility, global policymakers are showing much less appetite for 1980s-style international policy co-ordination. Not everyone views the Plaza and Louvre accords as a great success. Japan, in particular, blames the monetary easing agreed on at the time for the development of its bubble economy in the late 1980s, and hence as the root cause of today's problems. Europeans tend to see both accords as clever American tricks in which the Reagan officials pushed the burden of dealing with their past profligacy on to others.

Even if the Japanese and the Europeans could be persuaded to overcome their suspicions of a repeat, it is not clear that the 1980s remedies would work this time. Co-ordination is much harder these days because of the way policy is made, particularly given the rise of independent central banks. Back in the 1980s, the governments of Germany and Japan could tell their central banks what to do. Now both the Bank of Japan and the European Central Bank jealously guard their independence. Both in Japan and in the euro zone, central bankers see themselves as guardians of discipline against spendthrift politicians. That makes domestic fiscal and monetary co-ordination difficult enough, never mind any international efforts.

Moreover, the huge growth in capital markets has rendered currency intervention much less effective. With over $1 trillion in foreign exchange crossing borders every day, up from less than $200 billion in 1985, most economists now think that official currency intervention works at best at the margin, and then only if it is used to reinforce existing economic trends.

Lastly, big changes in the structure of America's trade patterns mean that more countries would have to be involved in any adjustment process. In 1985, Japan accounted for 16% of America's trade; now that share is down to 9%. Meanwhile Mexico, China and some other Asian countries have become much more important partners. A round of financial diplomacy involving policymakers in only five countries would no longer do the trick.

But the main difference between today and the mid-1980s is that the adjustment paths used last time round—a big shift in demand away from America towards Japan and Germany, together with a substantial but orderly drop in the dollar—are blocked. As the next two sections will argue, both Japan and Germany face big hurdles and wrenching economic reforms before either can become an engine of global growth in demand; and Asian countries, which account for a third of America's trade, are refusing to let their currencies appreciate, ruling out an orderly depreciation of the dollar. That makes the prospects a lot grimmer than before.
A pair of deadbeats
Sep 18th 2003
From The Economist print edition

Can Germany and Japan be reinvigorated?

THEY are the world's second- and third-largest economies. Measured at market exchange rates, Japan and Germany together make up about 20% of global output. And they are both in a mess.

Germany's economy has been stagnant for three years. It is the sickest in a region with many weaklings. Unemployment is running at 10%. Japan's economy has barely grown for a decade, the worst performance of any rich country since the Great Depression. Both unemployment and public debt levels have doubled over the past ten years. Very recently, however, it has begun to show signs of life.

Japan and Germany (along with the rest of western Europe) also face serious demographic challenges as their populations age and fertility declines. Fertility rates in both countries are well below the level needed to keep the population constant. With a median age of 41, Japan has the oldest population in the world. Germany, Italy, Sweden and Switzerland are close behind. These demographics will make Japan and western Europe the first victims of the pension time-bomb that hangs over most of the rich world.

In America, by contrast, the population is younger and both fertility and immigration are higher. According to projections by the United Nations, on present trends the median age of Americans, now 35, will rise by only five years by 2050, and the population will grow by over 40%. Japan's median age, on the other hand, will rise by 12 years to 53, and its population will fall by 14%. Germany's is due to drop by 4% and Italy's by 22%. Falling and ageing populations will make it harder to boost demand. As people age and their children grow up, they tend to save more and spend less, though usually after retirement a prolonged period of dissaving sets in.

But difficult demographics are only one factor. More importantly, continental Europe's and Japan's economies have miserably failed to live up to their own potential, thanks largely to home-made policy failures. Better economic policy could give both regions a shot in the arm, and would certainly help the global economy to rely less heavily on America.

Top of the list in both Europe and Japan must be structural reforms to make labour and product markets more flexible and, in Japan especially, to overhaul the banking system. In addition, both need better macroeconomic policy to make reforms politically viable and allow them to work.

Does either region have the political will for reform? And can such reform be introduced ahead of the coming American current-account adjustment, which will make the task that much harder?

Frozen in time
In Europe, Germany is clearly the toughest nut to crack. It is plagued with rigidities and saddled with a huge, unaffordable welfare state. As a result, its trend GDP growth rate, at 1.5%, is the lowest in Europe. Until recently, Germany was also the least interested in reform. While the rest of Europe started, tentatively, to free up labour markets in the 1990s (creating more than 10m new jobs), Germany did virtually nothing. So when the global economy weakened in 2001, Germany was hit the hardest. But at long last even Germany is beginning to make a move.

Four months ago, if you were planning a dinner party on a Saturday night in Germany and had failed to buy the food before 4pm, your guests would go hungry. Every shop would be shut, by law. But new opening hours introduced in June give the would-be Saturday host until 8pm to stock up. After that, he should head for the nearest petrol station, which can stay open much later. Though officially allowed to sell only “travel provisions”, petrol stations have stretched the term to include such obvious motoring essentials as wine, ice-cream and washing powder.

Nor is ice-cream after hours the only innovation. In March Germany's chancellor, Gerhard Schröder, launched "Agenda 2010", a package of reforms aiming to cut wage costs and make the economy more flexible. These include shortening the period during which unemployment benefit can be drawn, raising pension contributions and revamping health-care benefits. Mr Schröder also wants to bring forward a long-planned reduction in the top rate of income tax. The idea is to have all these reforms in place by the beginning of next year. Though this is far from certain to happen, there are encouraging signs. Mr Schröder has secured agreement from the opposition on sizeable chunks of the agenda, including health-care reforms and bringing forward the planned tax cuts.

If successfully implemented, Agenda 2010 would have big long-term benefits. It would make German labour markets substantially more flexible and reduce the burden on employers of high pension and health-care costs. In a recent study the IMF concluded that reducing the rigidities in Europe's employment and product markets to America's levels would boost the region's output by 10%. Agenda 2010 may not turn Germany into America, but according to Adam Posen, an expert on Germany at the Institute for International Economics in Washington, DC, it is the most ambitious package of reforms Germany has seen in 40 years.

Nor is Germany the only European country trying to make its economy more flexible. The French government passed a big pension-reform package in July, defying widespread strikes. Although the package excludes mollycoddled and strike-prone groups such as railway and utility workers, it goes much further than anything attempted before. Next on the agenda is the rationalisation of French health care, to be tackled later this year.

Fine efforts, but will these reforms (assuming they materialise) actually boost demand? After all, without higher domestic demand Europe will not be able to play its part in rebalancing the global economy.

In the long term the answer must be yes. Structural reform will allow Europe's economies to grow faster, thus allowing a sustainable rise in overall spending. But in the short term, the answer is less clear-cut. Reduced wage costs and greater flexibility should cause firms to invest more, but cutting long-cherished benefits and weakening safety nets may also prompt workers to save more, particularly if the overall economic environment is tough. That is why it is so important for Europe to get its macroeconomic policy right.

**Tight-fisted**

This presents a problem. For despite continental Europe's economic weakness, macroeconomic policy...
there has been far tighter than in America or indeed in Britain. This year, fiscal policy in America has been loosened by almost 2% of GDP, whereas in the euro area as a whole, and especially in Germany, it is being tightened (see chart 9).

The tight fiscal policy in Europe has resulted mainly from Europe's self-imposed policy strictures, particularly the Stability and Growth Pact. This requires countries in the euro zone to limit deficits to a maximum of 3% of GDP, other than in extraordinary economic circumstances. Countries that run excess deficits and fail to reduce them can be fined by the European Union. But the efforts to comply with the pact have led to perverse results. Earlier this year, for instance, Germany was talking about raising taxes in the middle of a recession to get its budget deficit down.

However, the roots of Europe's macroeconomic stance go well beyond the stability pact. Whereas America has rediscovered Keynes with a vengeance, European officials remain deeply sceptical about the ability of macroeconomic loosening, and particularly fiscal loosening, to smooth economic cycles. European economists, including several based at American universities, have spearheaded research that shows how, in theory, fiscal tightening (especially spending cuts) can actually boost the economy. A recent study by the European Commission claimed that roughly half the instances of fiscal tightening in the EU during the past decade had been followed by faster economic growth. Conversely, they argue, the evidence that fiscal expansion works is much thinner.

They have a point. Given that Europe's overall fiscal position is worse than America's—with higher tax rates and bigger debt burdens—there is less room for loosening and greater benefits to be reaped from discipline. But that does not mean that fiscal policy has no role to play.

Indeed, Europe's big economies now seem to be coming round to the view that it has. France, Germany and Italy, as well as Portugal, are currently flouting the 3% ceiling on deficits. Yet Germany is hoping to bring forward much-needed tax cuts that are likely to make the deficit worse. France, too, looks set to breach the stability pact again next year and Jacques Chirac, France's president, advocated a "temporary softening" of it this summer. The point is not that Europe can, or should, spend its way out of the current downturn, but that fiscal policy should avoid aggravating cyclical downturns. With luck, that trend has now started.

Monetary policy in the euro zone has also been tighter than in America. Since the beginning of 2001 the European Central Bank (ECB) has cumulatively cut short-term interest rates by 2.75 percentage points, whereas the Federal Reserve has cut short-term rates by 5.5 percentage points. Here, too, the differences are partly due to intellectual attitudes and partly to self-imposed rules.

Whereas Alan Greenspan, the chairman of the Federal Reserve, has adopted the role of recession-avoider-in-chief (in line with the Fed's goals of maximising employment as well as stabilising prices), Europe's central bankers have been dogmatic inflation fighters (their only official goal being inflation close to, but below, 2%). They are also self-styled drill-sergeants for structural reform.

Despite widespread criticism from the IMF, the OECD and the financial markets for cutting rates too
slowly, the ECB remains unabashed. Wim Duisenberg, the bank's boss from its inception, once famously quipped that a bout of falling prices was a central banker's dream. He has regularly claimed that Europe's problems are structural, not monetary. Jean-Claude Trichet, a former governor of the Bank of France, who is expected to take over from Mr Duisenberg in November, may take a softer line.

But it is not just a question of personality. A large part of the difficulty lies in making policy in a currency union of 15 disparate economies. The ECB's decisions on interest-rate changes are based on region-wide inflation averages, which across the euro zone as a whole have consistently bumped up against the ECB's target of 2%. However, inflation in Germany—which makes up 30% of the euro zone's economy—has been rather lower than the average. So interest rates that are appropriate for the euro zone as a whole are too high for Germany.

To aggravate matters, Germany has a much weaker banking system than the rest. Like Japan, it has too many unprofitable banks that need rationalising and restructuring. While this is being done, banks are reluctant to lend, so credit growth is stagnant. The pessimists about Europe say that the state of Germany's banks, its structural rigidities and its low inflation raise the spectre of Japan-style deflation that could sink the economic prospects of the entire euro zone.

**Do trains pull locomotives?**

Optimists about Europe—of whom there are a few—suggest that whereas the ECB may not have loosened interest rates enough for Germany, its cuts should be enough to get demand going again in the rest of the euro zone. Growth there, they argue, will eventually pull Germany along too. Analysts at Goldman Sachs, for instance, point out that real interest rates outside Germany are negative, and that the euro zone as a whole has a relatively healthy balance sheet and little spare capacity. They reckon the ECB's rate cuts so far will be enough to boost the growth in domestic demand in France from 1.1% this year to 3.1% next year and in Italy from 1.4% to 2.9%.

Given Germany's weight in continental Europe, the idea of robust European growth without Germany seems a stretch. But whether the macroeconomic optimists or pessimists win the day depends in large part on what happens to the euro.

The lobby of the ECB's Frankfurt headquarters is decorated by a large round mural of the euro currency, half bathed in sunshine and half submerged under water. This strange installation symbolises the risks facing Europe, and hence the world economy. If the euro emerges too quickly into the sunshine, it could sink Europe's economies, because the overall economic effect of a stronger euro is similar to a tightening of monetary policy. Indeed, the ECB's rate cuts this year have barely offset the rise in the euro. A further drop in the dollar and appreciation in the euro, particularly a sharp one, would soon far outweigh any monetary loosening from the ECB. Tighter macroeconomic conditions would not only deter growth in demand, but would also make much-needed structural reforms politically more difficult.

In short, a fast-rising euro, which could take some of the pressure off America's current-account deficit, could harm Europe's economies, and hence any hope that a second engine for the global economy might get started.

If Europe's macroeconomic policies have made a difficult situation worse, then Japan's have turned a structural problem into a slow-motion disaster. Although the details are different, the broad script—necessary structural change put off and then made harder by macroeconomic ineptness—is exactly the same.
Will the sun ever rise?

Japan's main problem is its inability to restructure the financial system that collapsed after the 1980s bubble economy burst. Too many bust banks remain open, keeping too many unproductive firms alive and locking resources into weak areas of the economy. The prescription is simple: Japan's banking system needs an overhaul to create a more effective system of credit intermediation which, in turn, would force much-needed corporate restructuring. Yet for a decade the government has failed to come to grips with the problem. This has caused the economy to stagnate and get caught in a deflationary cycle. With prices falling, the real value of the debt held by Japan's bankrupt banks and firms has risen, deepening the financial quagmire.

Conventional wisdom argues that Japan tried, and used up, all the traditional fiscal and monetary tools. Though government debt doubled and short-term interest rates fell to zero, the economy stayed in a rut. Keynes seems to have failed.

The reality is more subtle. As the IIE's Mr Posen, and Kenneth Kuttner, of the Federal Reserve Bank of New York, have persuasively argued, Japan's fiscal policy has on balance been tight. Despite intermittent huge public-spending programmes, they point out, over 80% of the increase in Japan's public debt has been due to lower tax revenues from a shrinking economy.

On the monetary side, the Bank of Japan did too little, too late. It was slow to cut interest rates after the bubble burst in 1990 and refused to reflate the economy by printing yen to buy government bonds or other assets. Though there have been tentative efforts in that direction during the past year, they did not pack enough of a punch once deflationary expectations had set in. Instead, Japan's most proactive macroeconomic policy has been massive intervention in the currency markets to stop the yen appreciating against the dollar and cutting off the relatively small but vibrant export sector. So far this year the Japanese government has spent around $80 billion buying dollar assets. In other words, Japan's only policy has been to stave off the dollar devaluation that would help to rebalance the world economy.

Can Japan sort out this mess? At first sight, the task looks more manageable than Germany's. Japan's problems are concentrated in the financial sector, whereas Germany's span the entire economy. But unlike Germany, Japan is showing no sense of urgency, nor does it have a clear reform agenda. There have been some signs of progress, particularly the government's recent bail-out and restructuring of Resona bank. But there is still little evidence that policymakers are willing to undertake large-scale financial reform.

A number of outside observers have concluded that Japan must be forced to undertake structural reform by letting its currency appreciate substantially. They argue that during the second half of the 1990s the weakening of the yen allowed Japan to put off structural reform, and that now the government is deliberately putting it off further through its currency intervention. A much stronger yen would bring about the much-needed structural reform, at the same time as helping to reduce the American current-account deficit.

A little arm-twisting

Fred Bergsten, head of the IIE, is one of the most vocal proponents of this thesis. In a recent testimony to Congress he said America should tell the Japanese to stop intervening to keep down the yen. If necessary, the administration should threaten to sell dollars to offset the Japanese efforts. However, many economists disagree with Mr Bergsten, arguing that the tighter macroeconomic environment created by a sharply raised exchange rate would aggravate deflation and make the banking reform unnecessarily painful. Even John Snow, America's Treasury secretary and the man ultimately
responsible for any currency intervention, acknowledged that Japan's desire to stop its currency appreciating is understandable. "They need a strong export sector to get their reforms done," he said this summer.

More important, the process of reflation—crucial to getting Japan out of its mess—is likely to mean a weaker rather than a stronger currency, at least in the short term. There is a growing consensus among Japan-watchers, led most recently by Ben Bernanke, a governor of America's Federal Reserve and a renowned monetary economist, that an ambitious combination of fiscal and monetary easing, coupled with a clear inflation target, would jolt Japan out of its deflationary spiral. In a recent speech in Tokyo, Mr Bernanke argued in favour of big tax cuts financed by the purchase of government bonds by the Bank of Japan.

This might prove the surest route to boosting Japanese demand, but it is unlikely to strengthen the yen, at least in the short term. And even as it got the Japanese economy going again, thus helping to reduce the world's over-dependence on America, it would aggravate another problem which adds to that dependence: the extreme reluctance of most of America's Asian trading partners to let their currencies appreciate.
Oriental mercantilists
Sep 18th 2003
From The Economist print edition

Asia's addiction to cheap currencies must end. But not overnight

THE average homeowner in Peoria has probably never heard of Toshihiko Fukui, Zhou Xiachuan, Joseph Yam, Perng Fai-nan or Park Seung. But he has a lot to thank them for. These men, respectively bosses of the central banks of Japan, China, Hong Kong, Taiwan and South Korea, have become the world's most enthusiastic purchasers of American government debt, including that of the mortgage giants, Freddie Mac and Fannie Mae. Their appetite for Freddie's and Fannie's bonds keeps the dollar relatively strong, and mortgage rates in Peoria down.

Between them, these five Asian central banks hold around $1.3 trillion in official reserves (or over half of the global total), most of them in dollar assets. Since December 2001, Japan's reserves have shot up by 36%, China's by 65% and Taiwan's by 49% (see chart 10).

The Asians' passion for American bonds is explained by their desire to stop their currencies appreciating against the dollar. China and Hong Kong fix their currencies against the dollar, in Hong Kong's case through a currency board. That means a current-account surplus or big capital inflows automatically translate into higher reserves. The other countries ostensibly let their currencies float, but heavy intervention by central banks has ensured that Japan's yen and South Korea's won have risen by over 13% against the dollar since the beginning of 2002, compared with a 25% increase for the euro, another floating currency (see chart 11).

For the man from Peoria (and for America's economy), this has brought a short-term benefit. The dollar's fall over the past 18 months has been smaller and more gradual than it would have been without the Asians' intervention. The trouble is that the Asian dollar binge is putting off the inevitable adjustment to America's current-account deficit. America continues to accumulate foreign debt at an ever faster rate, so the eventual adjustment will be correspondingly bigger. At the same time a disproportionate share of whatever decline in the dollar does materialise falls on those countries that let their currencies float, especially the euro.

Crying foul
Small wonder, therefore, that complaints about the Asians' behaviour are getting louder. When Europe's finance ministers met their Asian counterparts at a summit in Bali in July, they made a fuss about those weak currencies. America's Treasury secretary, John Snow, went to China earlier this month specifically to lobby for a change in the exchange-rate regime. And tensions are rising within Asia itself. The Japanese are unhappy about the undervaluation of China's currency, and the South Korean government recently suggested that China should allow the yuan to appreciate.

Broadly speaking, those complaints are justified. Asia's currencies must play a part if the world is to stop relying on the single American engine. But too many of Asia's critics oversimplify both the dilemma facing the world economy and the difficulties facing individual Asian countries.

In the short term, Asia's central banks are right to claim that they are supporting the world economy, not undermining it. Were Mr Fukui and his friends to give up on American bonds overnight, the dollar would plummet and bond prices would soar. To help the world economy, the adjustment needs to be gradual—a point that is often lost on the shrillest foreign critics.

Second, Europeans, especially, tend to exaggerate how much they are suffering. True, the euro has borne a disproportionate share of the dollar's adjustment so far, but without the Asians' interventions the fall in the dollar would have been steeper, so in the short term the Europeans may not be much worse off. The point is not that the Asians are harming the Europeans in particular, but that they are preventing the adjustment of America's imbalances, making the long-term problem worse.

Third, although Asia's central banks are all doing the same thing (buying dollars), their economies are by no means all in the same boat. This suggests that no single solution will suit everyone.

**Too much of a good thing**

Rising foreign-exchange reserves are not necessarily a bad thing. Countries need reserves to guard against sudden shocks; say, a big drop in exports or an unexpected drying-up of foreign lending. As economies grow, so the level of reserves tends to rise. In general, more open economies need more reserves than those where foreign trade is less important; and those with a fixed currency, such as China, need more reserves than those with a floating one.

Reserves are particularly important for emerging economies. As these countries open up to foreign capital, they need relatively more reserves. That was one painful lesson of the 1997-98 Asian financial crises, when several emerging Asian economies turned out to have insufficient reserves given their level of short-term foreign debt.

After these crises, Asia's emerging markets rapidly built up their arsenal of foreign exchange. According to an analysis in the IMF's latest *World Economic Outlook*, this build-up was justified by economic fundamentals until about 2001. Since early 2002, however, reserves have rocketed and are now unnecessarily high.

The suspicion, therefore, is that Messrs Fukui, Zhou, Fai-nan and company have been buying dollars for nefarious reasons: to keep their exports artificially cheap and hold on to their traditional export-led growth. Exports now make up 64% of the region's GDP, up from 55% in the early 1990s. Asians seem to like it that way. Yusuke Horiguchi, chief economist of the Institute of International Finance and former top Asia expert at the IMF, talks of a "deeply rooted mercantilist instinct" in Asia "with an almost
religious attachment to trade and current-account surpluses”.

But this passion for trade surpluses is not without its problems. Not only does it prevent Asians from playing their part in rebalancing demand away from America, it also contravenes the rules of world trade. The charter of the IMF prohibits a country from manipulating its currency to “gain an unfair competitive advantage” over its trading partners.

The definition of manipulation includes protracted large-scale intervention in one direction in the exchange markets. That sounds suspiciously like what the Asians have been doing. Unfortunately there is no simple answer, because all the countries' problems are different.

Japan is by far the region's biggest economy. Unlike the others, it is a rich industrial country which has been running a current-account surplus since 1981. It already has the largest dollar reserves in the world, and is accumulating more at a rapid clip. All this suggests that Japan should take the biggest share of any dollar adjustment in Asia. Yet, as the previous section explained, the country suffers from chronic deflation. A sharp appreciation in its currency right now could undermine any hope of boosting growth in the short term. On balance, therefore, most analysts have concluded that a boost to Japanese demand will be more helpful to the world economy than a stronger yen. On economic grounds that is the right choice, but politically it will make it harder to persuade other Asian countries to let their currencies appreciate.

Collectively, the other dollar-buyers in Asia pack an even bigger economic punch than Japan. China, South Korea, Taiwan and the region's other emerging economies together account for 20% of world trade, compared with Japan's 5%. Their combined current-account surplus in 2002 was $133 billion, larger than Japan's ($113 billion) or the euro zone's ($72 billion). That is why they must play a big part in any global economic adjustment.

China, in particular, is crucial. Leaving aside Japan, it is the region's giant, with by far the fastest-growing economy and the biggest stash of reserves. Most Asian countries are terrified that China will beat them on every product, so no country will allow its exchange rate to rise unless China's does too.

China's currency, the yuan, has been fixed at 8.3 to the dollar since 1994. In the late 1990s China's fixed currency won it many plaudits. As other currencies in Asia succumbed to financial crises, the yuan remained stable (appreciating sharply against the rest of Asia). China was credited with preventing a round of dangerous competitive devaluations.

Now, however, China's attachment to its fixed rate generates hostility. After years of fast growth and huge inflows of foreign investment, claim the critics, the yuan should be stronger. Instead, as the dollar has fallen over the past 18 months, the Chinese currency, in effect, has fallen with it. Clearly, they say, the yuan is undervalued.

In evidence, they point out that, according to economic theory, exchange rates in countries with rapid productivity growth should be appreciating. China's economy has been growing much faster than the rest of the world, and its current account has been in surplus since 1994. For a fast-growing emerging economy with high levels of investment, a current-account deficit would be more normal. Moreover, capital is pouring into China. Last year it was the world's largest recipient of foreign direct investment, with inflows totalling $53 billion. Like trade surpluses, large capital inflows should push up the currency. Lastly, the huge and accelerating build-up of reserves suggests that, left to its own devices, the yuan would appreciate.

Estimates of the degree of undervaluation differ wildly. According to The Economist's informal measure of currencies, the Big Mac index, the yuan is undervalued by a whopping 56%. Ernest Preeg, an
economist at America's Manufacturers Alliance, argues that if normal market forces applied, the yuan would rise by 40%. A recent study by UBS, a bank, put the figure around 20%. Others reckon it might be only 10-15%.

The problem is that traditional gauges of undervaluation do not work well in an economy with tight capital controls and in the midst of colossal structural changes. Nobody can be sure that China's currency really is grossly undervalued. And if it is, it may not remain so for long.

For a start, the scale of China's current-account surplus is frequently exaggerated. Many Americans think it has a huge overall surplus when in fact it has a large, and rising, bilateral trade surplus with America, which is now bigger than Japan's bilateral surplus (see chart 12). China's overall current-account surplus, on the other hand, is much smaller than Japan's, and is shrinking fast. In the first few months of 2003, China's trade balance was actually in deficit.

This may reflect temporary factors: higher oil prices in advance of the Iraq war, and a one-off surge in imports delayed to take advantage of tariff cuts introduced on January 1st. But it may also reflect a longer-term trend towards higher imports of capital and consumer goods. China's imports have been growing at an annual rate of over 40% a year recently, even faster than its exports (30% plus). Many of those imports are inputs for exports, but not all. According to Nicholas Lardy, a China expert at the Institute for International Economics, there are signs that imports are being fuelled by rising domestic demand. Car imports, for instance, are up more than 60% on last year. The big tariff cuts associated with China's entry into the WTO may push up import growth even further. If Mr Lardy is right, and China's imports are set to grow rapidly even at the current exchange rate, the case for a large appreciation looks weaker.

Evidence from the capital account must also be treated with caution. Yes, China has recently been the world's biggest recipient of direct investment, but according to Mr Lardy, many capital inflows have been speculative, and might easily reverse themselves. Chinese companies, expecting a revaluation of the yuan, are bringing home money that they had illegally stashed abroad. Mr Lardy reckons that these "unrecorded inflows" make up a big share of the recent rise in reserves.

Those who call upon China to revalue also point to its highly controlled capital account and its distorted financial markets. A good dose of deregulation, they say, would break China's mercantilist plot. But they may be overstating their case. One result of China's capital controls is that its citizens and firms cannot legally keep their money abroad, but must entrust it to the country's troubled banking system. According to many China watchers, this means there is a huge pent-up demand for foreign assets.

Andy Xie, an economist at Morgan Stanley, points out that Hong Kong residents hold an average of $30,000 each in foreign currency, whereas in mainland China the figure is a mere $100. If Chinese residents could hold more dollars, he argues, they would. Mr Lardy says that the distribution of deposits in Chinese banks is highly skewed. A small number of rich people account for a huge share of total deposits. These richer, more sophisticated Chinese, he argues, would quickly shift to dollars if they could, so that whenever China gets round to loosening its capital controls, it could see big capital outflows. The yuan might even fall, not rise.

In short, it is hard to determine whether the yuan is undervalued today. It is even harder to determine how far, and in what direction, it should move in future as China becomes more integrated into the
world economy.

There is a much clearer argument for making China's currency more flexible. A flexible exchange rate would allow the yuan to move as capital and trade conditions shifted, and would give the government the monetary autonomy to deal with economic shocks. And indeed, China says it is gradually moving towards a more flexible exchange-rate regime. But there are few signs that this is really happening. The government is deeply worried about the instability that might result. For some years it has derived its legitimacy, such as it is, from the country's continuing economic boom. It fears that meddling with the currency could raise unemployment, aggravate deflationary pressures and cause a meltdown in the banking system.

Many of these fears are overblown, especially those about deflation. True, prices in China until recently were falling slightly, but much of that has to do with huge productivity improvements and excess capacity in state-owned firms, not with overall economic stagnation. It is hard to see how an economy growing at more than 7% a year can face a Japan-style deflation problem.

The price of stability

A fixed currency may bring stability, but at a price—to China as well as to the world economy. Part of that price is the returns forgone when the Chinese authorities pile up mountains of reserves: they are holding low-yielding American government debt rather than investing the money more profitably at home. There is also the risk of financial distortion. As Alan Greenspan recently pointed out, China's accumulation of reserves will eventually distort its monetary system. As the central bank builds up reserves by buying dollars, it must pay out yuan. Either this growth in the money supply is sterilised—which means selling domestic bonds to mop up the excess liquidity, an increasingly expensive process—or domestic liquidity will rise rapidly, which could overheat the economy and cause financial bubbles. Domestic credit has already been soaring (relative to GDP, it was up 38% in the first half of 2003), leading to isolated property bubbles and a string of financial scandals. The longer this continues, the higher the risk of large-scale financial bubbles.

To avoid this, China's government has been trying to reduce pressure from the reserve build-up, but without touching the yuan. It has slightly relaxed restrictions on residents' purchases of foreign currency; allowed firms to keep a bigger share of their foreign-exchange earnings; and announced plans to allow some Chinese firms to buy foreign bonds and stocks from later this year. These tentative steps towards a more open financial system are worth taking. But they should be accompanied by a move towards greater flexibility of the currency system.

This need not mean an immediate floating of the yuan. The currency could float freely only if capital controls were substantially lifted. Given the parlous state of China's banks, such a big bang would be far too risky. A main lesson of the Asian crisis, after all, was that financial opening needs to be handled carefully.

Nor does re-pegging the yuan at a higher fixed rate seem a sensible option. For a start, nobody really knows how much the yuan should rise, if at all. Besides, a new peg would do nothing to prepare the exchange-rate regime for dealing with future economic shocks.

The best thing China can do—both for its own economy, and to help global economic adjustment—is to tie the yuan to a broader basket of currencies, including the euro, and widen the band within which it can move. Increasing the wiggle room would allow the yuan to appreciate, making the global adjustment a bit easier. And by broadening the basket of currencies, China would ensure that it did not simply follow the dollar when, as this survey predicts, the greenback heads down further.
Drag the others along

If China were to move to a more flexible currency regime, the chances are that other emerging economies in Asia too would let their currencies move within wider margins. These countries do not face the risk of sudden capital flight or financial-sector collapse. Unlike China, they have relatively sophisticated financial systems and freer capital flows, which suggests that they are better placed to cope with stronger currencies. Politically, however, any movement without China is impossible. China is not just perceived as a competitive threat by many Asian economies; it is also their biggest export market.

In sum, the safest outcome in the next couple of years for emerging Asia, as well as for the global economy, is not a huge jump in exchange rates, but a gradual strengthening. The world economy will still be relying on Messrs Fukui, Zhou, Yam, Fai-nan and Seung to buy dollar assets, but not quite so many of them.

If, on the other hand, China's leadership does nothing about the yuan, protectionist pressures may become irresistible, particularly in America. That would be a disastrous outcome, for China as much as for everyone else.
**Raising the barricades**

*Sep 18th 2003*

From The Economist print edition

**If the global economy falters, free trade will suffer**

“**I’m MAD as hell,**” roared the man on stage. “**Mad as hell about what is happening to the manufacturing sector in America.**” “**This is a trade war with China,**” shouted his colleague, “and it's time to fight that war head on.**”

The audience cheered in approval. Patriotic songs played in the background, interspersed with extracts from George Bush's address to the nation after September 11th. Banners waved. “**Leave China in the sink,**” said one. “**Free trade is a myth,**” said another.

This was August 1st, dubbed Manufacturing Awareness Day in Connecticut by a new anti-China trade group called “**Mad in USA**”. In recent months, several such grassroots groups have sprung up across America's manufacturing heartland. They represent mainly smaller businesses (big firms are buying from China, or moving their manufacturing there), and promote a mixture of protectionism and patriotism. On the website of “Save American Manufacturing”, a Wisconsin-based group, a cartoon Uncle Sam urges you to “join the fight to stop the de-industrialisation of the United States”.

As yet these groups are small, but China-bashing is a growing phenomenon. With 2.7m manufacturing jobs—one in six—lost during the past three years, people are looking for a scapegoat. Japan served in that capacity when its trade surplus with America was soaring in the 1980s; now it is China's turn.

Over the summer, complaints about China have become a big political issue in Washington, DC. Congressional committees have held hearings about unfair competition from China, and particularly its cheap currency. Mr Bush’s rivals sense a winning issue. Joseph Lieberman, a Democrat contender and supposed free-trader, has accused China of “economic attack”. Mr Bush's economic team is worried that the China issue will escalate as the election nears, particularly if the jobs outlook remains glum.

They are right to be concerned. The political backlash in America is likely to gain momentum as China’s role in the global economy becomes ever more prominent (see chart 13). This is not a temporary blip that relies on a cheap currency. It is a structural shift based on economic reform, huge reserves of cheap labour and a rapidly improving infrastructure.

China's integration promises vast benefits for the global economy, but it comes at an awkward time. During the 1990s, protests against globalisation, though vocal, were relatively ineffective. Political pressure for protection in rich countries was subdued as economies boomed. Now, with weak economic growth and higher unemployment, the potential for protest is much greater. The loss of blue-collar and, increasingly, white-collar jobs is more keenly felt as firms outsource or move their factories abroad. In poor
countries, too, the “China threat” seems more acute when export markets are weak.

And there are more China-related shocks on the way. At the end of 2004, the Multifibre Arrangement, a quota system that has governed, and distorted, the world textile market for decades, is scheduled to expire. Apart from agriculture, textiles and clothing are among the last products where governments rather than markets determine trade patterns. China, with its army of low-paid workers, will be a big winner from the demise of this regime. According to Mr Lardy, its share of the American clothing market, for instance, could zoom up from 12% in 2002 to 30% once restrictions are lifted.

America's small but highly protectionist and politically sensitive textile industry will be hurt, and will shout. But it is other developing countries that will feel serious strain. Textile production is the first rung on the manufacturing ladder for many poor countries. The quota system has guaranteed such countries access to America and other rich-country markets. Without quotas many will lose out to China. Their protests will coincide with rising anti-China sentiment in American manufacturing, creating an atmosphere in which protectionism could flourish.

America's government has plenty of tools to use. Under the terms of China's entry into the WTO, a number of “safeguards” allow countries to slap tariffs on Chinese goods if they are deemed to be causing “market disruption”. These temporary safeguards can be used for all goods until 2014. For textiles there are additional, even more broadly defined safeguards that apply until 2008.

So far the Bush administration has shown remarkable restraint in their use. Of a handful of safeguard applications filed by American industries, two have reached the White House: one by American producers of pedestal actuators (devices used in, eg, electric wheelchairs) and another by American producers of wire coat hangers. Both were turned down.

One reason for the restraint is a desire to maintain cordial relations with China, not least for geopolitical reasons. Since September 11th the Bush team has courted China as an ally in the war against terrorism. Its help is particularly crucial in dealing with North Korea. But as the election looms, domestic political considerations will play an increasing part. The Bush team has jettisoned its free-trade instincts in the pursuit of votes before, and may well do so again in 2004. Many trade-watchers in Washington fear the introduction of a mass of safeguards and anti-dumping tariffs, and a rapidly souring economic relationship with China, especially if there is no movement on the yuan.

Nor is China the only area where trade spats are likely to intensify. The transatlantic trade relationship, too, will see more disputes, particularly if the euro rises. An appreciating euro will put European industry on the defensive, though that defensiveness is unlikely to translate into a flurry of anti-dumping and safeguard actions. Europe's trading relations are handled at the level of the European Union, not individual countries, which makes Europe's trade policy less litigious than America's. The hurdles that a European firm must clear to persuade the European Commission to press an anti-dumping case are much higher than those faced by an American firm.

That does not mean Europeans are less protectionist; simply that the tactics are different. There may be political pressure in Europe to enforce rulings the WTO has already made against America, notably in the case about America's foreign-sales corporation tax, a tax break given to American exporters. The WTO has ruled that the American tax break was an illegal export subsidy and given the Europeans permission to levy up to $4 billion in retaliatory tariffs. So far they have held off, waiting for America's Congress to rewrite the offending parts of the tax code. But it is far from clear that such a change will actually be passed. The chances are that the dispute will rumble on, and pressure in Europe for
retaliatory tariffs may rise.

Americans, for their part, increasingly view Europe's regulatory requirements—ostensibly designed to protect consumers or the environment—as a form of protectionism through the back door. One example is the continuing row over genetically modified crops. America has threatened to appeal to the WTO over the moratorium the Europeans have imposed on approving GM crops. American producers reckon that even assuming the moratorium is lifted, Europe's new labelling requirements for GM products are too onerous and protectionist.

A potentially even bigger fight looms over Europe's proposed regulations on chemicals, which require manufacturers and users of chemicals to give extensive information on the health and environmental effects of all their products. Here, too, Americans smell European protectionism.

After Cancun

Set beside the huge importance of the transatlantic trade relationship, each of these issues is an irritant rather than a threat. There is little risk that transatlantic trade will be engulfed by a wave of protectionism, even if the dollar plummets. But at a time when economies are already fragile, such trade spats add unwelcome political tensions. More important, after the collapse of last week's WTO ministerial talks in Cancun, they make it even less likely that the Doha round of global trade talks can be revived.

The Doha round, launched soon after the September 11th attacks, has ambitious goals, geared particularly to helping poor countries. Dubbed a development round, it aims to free up farm trade, long the sacred cow of global protectionism; slash remaining tariffs on industrial goods; and liberalise trade in services. The potential benefits for the global economy, and especially for poor countries, would be considerable. According to the World Bank, a successful Doha round could raise poor countries' income by $350 billion a year and lift 144m more people out of poverty by 2015.

These gains are now in serious jeopardy. Last week's ministerial summit in Cancun—which was supposed to mark the mid-point of the round—collapsed in disarray on September 14th, with rich and poor countries unable to agree about the scope and ambition of the Doha round. Poor countries, particularly African ones, refused to extend the negotiations into new areas, and accused the rich countries of refusing to make serious efforts to dismantle their egregious farm subsidies. Negotiations are to continue in Geneva, but the official deadline for finishing the talks—December 31st 2004—now looks certain to be missed.

At first sight, that should not matter too much. Experience shows that trade rounds always drag on much longer than planned. Doha's predecessor, the Uruguay round, took eight years to complete, rather than the three originally scheduled. But this time is different. The WTO, an organisation already short on credibility, has been dealt a body blow. Moreover, the environment in which the talks take place is likely to become increasingly hostile to freer trade. Europeans, under pressure from an appreciating euro, will find it harder to sell more farm reform at home. Poor countries, worried about China, will become even more leery about lowering their own barriers. America, with its growing trade deficit, will find it ever harder to argue for free trade. And the president's fast-track negotiating authority—under which Congress can approve but not alter trade agreements—runs out in 2007. If the mood in Congress turns against trade liberalisation, the authority may not be renewed.

These risks are not lost on Mr Bush's trade team. They are one reason why Bob Zoellick, America's top trade man, is a strong proponent of “competitive liberalisation”. America is simultaneously negotiating global, regional and bilateral trade deals because the momentum has to be kept going. Engaging
Congress in new trade deals, he says, stems the slippage towards protectionism.

Underlining his point, President Bush has just signed free-trade agreements with Chile and Singapore. In the past year, the Bush team has initiated bilateral trade deals with all the Central American countries and five countries in southern Africa, as well as Morocco and Australia. It has also promised to start trade talks with Bahrain and the Dominican Republic. More are likely to follow. After the failure of the Cancun talks, Mr Zoellick said that America would now push on the bilateral and regional route.

Bilateral trade deals, particularly with small countries, are much easier to get through Congress than multilateral ones. But success at bilateral trade deals coupled with a lack of progress on the Doha round would gradually create a different kind of global integration. From an economic perspective, a spaghetti bowl of bilateral trade agreements is much less desirable than progress towards multilateral free trade. Moreover, America's choice of bilateral free-trade partners so far suggests politics plays as much of a role as economics in defining the administration's agenda.

Already free-traders argue that America is interested more in economic "coalitions of the willing" than in global free trade. Jagdish Bhagwati, an economist at Columbia University and a vocal free-trader, says America's behaviour is that of a selfish hegemon. The country's appetite for bilateral deals, he claims, is undermining the global trading system. That is unfair, because the Bush team has worked harder than many others to make progress on the Doha round. Certainly the Americans share some of the blame for the collapse at Cancun. Their unwillingness to offer poor African countries more concessions on cotton was particularly unhelpful. But poor countries' intransigence was just as much of a problem.

Whoever bears the responsibility, though, bilateral trade deals are no substitute for progress towards multilateral free trade. On current trends, depressingly, it seems that the global trade system is heading for second-best.
Leadership and luck
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From The Economist print edition

The world economy needs both

TO GET a sense of the challenges facing the global economy, fast-forward four years to September 2007 and consider the following three scenarios:

• The world's top finance ministers arrive in Washington for an emergency summit after the dollar has crashed and financial markets have seized up. Foreigners are deserting American assets following the announcement of a $50 billion derivatives loss at Fannie Mae, America's mortgage giant. Bond yields have soared three percentage points in two weeks; the dollar is down 40% over the same period. Several large banks are rumoured to be on the brink of collapse.

• With America's trade deficit topping $800 billion and the budget deficit close to 7% of GDP, Congress is in a protectionist frenzy. A bill sponsored by Hillary Clinton, the leading Democrat contender for the presidency in 2008, to impose a 25% surcharge on imports from all countries with large trade surpluses looks set to pass. More radical legislation calling for America to leave the WTO is gaining support.

• After six years of poor growth, America's economy has been widely written off. The dollar is weak, and the administration is preoccupied with painful budget cuts. Top of the business bestseller list is a new book by Lester Thurow called "A Haemorrhaging Hegemon: How America's Economy Owed the '90s and Flunked the Millennium". Attention has shifted to Europe, where productivity and investment are soaring. China remains the world's most buoyant economy, but Japan, too, is growing at a fair clip, catching up after a decade of stagnation.
Of course these scenarios are flights of economic fancy, but they make two serious points. First, the world's reliance on America as its only engine is increasingly risky. Second, moving away from a one-engined world will not be painless. In America, in particular, the economy is likely to remain weak for the next few years. That may sound depressing, but sluggish growth for another half-decade is much better than a dollar crash, a deep recession or a stampede into protectionism.

A sudden dollar crash precipitated by a big shock in America's financial markets may not be likely, but it is certainly possible. The longer that America's current-account deficit—and hence its reliance on foreign capital—continues to grow, the greater the risk that a shock to America's financial markets will send the dollar crashing. This would probably push the world economy into recession. Spiking interest rates would deflate American consumer spending. A soaring euro would darken Europe's economic outlook. If the euro rose far and fast enough, it might even put European monetary union at risk. And poor countries would be hit by a double whammy: a sharp drop in export earnings as the rich world plunged into recession, and a sharp rise in interest rates as investors abandoned risky assets.

**Protect us from protectionism**

But a dollar crash and global recession are not the only gloomy possibilities. Equally worrying, and much more likely, is a surge in protectionism, especially if America's current-account deficit continues to rise rapidly. In 1985, Congress seriously considered an import surcharge of the sort described in the imaginary scenario above. Many American politicians are already ambivalent towards the WTO. If the government loses a few more big trade cases, that ambivalence could turn to antipathy.

A slide into protectionism would have grave consequences. Since the end of the second world war, America has championed the multilateral approach to freeing global trade, though with varying enthusiasm. If it were to give up this leadership role, even temporarily, the global trading system would be in deep trouble. The WTO is a fragile organisation, less than ten years old. It would not survive a lengthy period of American disengagement.

The intellectual consensus in favour of free trade, particularly in poor countries, could also wither in the face of American protectionism. Poor countries would ask why, if it was fine for America to raise barriers against the Chinese threat, they should hold back from doing the same. Given that trade integration plays a crucial role in economic development, the world's poorest would find it that much harder to escape from poverty.

The most important message, however, comes from the third and most optimistic scenario. It is that the best outcome the world economy can hope for in the next few years is a fairly sluggish performance by America's economy, combined with faster growth elsewhere. A few more years of below-average growth but no serious recession would help America to work off its excessive debt and increase its savings rate. The best-case scenario would be for both Europe and East Asia simultaneously to pick up the slack. That would allow the dollar to decline gradually rather than crash; but with relatively slower growth at home and faster growth abroad, America's current-account deficit could be trimmed sharply. Just when Mr Thurow published his book on hegemonic decline, America would be set to prove him wrong (once again). With the imbalances worked off, its highly productive and flexible economy would be ready to roar.

Sadly, the chances of such a gradual adjustment are not good. The trend remains towards ever bigger American imbalances and continued reliance abroad on American economic growth. European and Japanese leaders seem to take this for granted, much as they rely on America's security umbrella. Reversing that attitude, and with it the trend towards ever bigger American indebtedness, will take political leadership as well as a large dollop of luck.
Yet to judge by their rhetoric, today's politicians have little sense of the mess that the world economy is in. The Bush administration does not even acknowledge that there is a problem. Europe's leaders are too busy squabbling over who has broken the Stability and Growth Pact's 3% deficit target to see the global economic picture. And Japan's politicians spend too much time bad-mouthing China and too little offering solutions to their own economic troubles.

This must change. The Europeans and Japanese need to understand that they are not only facing a demographic hiatus of their own, they are also operating in a global economy that could come seriously unstuck unless they act soon. China's leaders, too, need to make the connection between their own economic policy and the global picture. Unless they loosen their dollar peg soon, they will find the protectionist backlash against them will get a great deal worse.

The heaviest responsibility to act differently, however, falls on America itself, which is as guilty as anybody else of causing the world's current lopsidedness. And until Mr Bush's economic team acknowledges the size of the problem, others will hide behind American nonchalance.

In the 1980s, the turning point came when James Baker, Mr Reagan's Treasury secretary, acknowledged the global imbalances and recognised the risks involved. He instigated the Plaza Accord not out of an idealistic commitment to the global good, but because the global imbalances imperilled America's own prospects.

Mr Bush's current team need not—and, as this survey has argued, probably could not—replay the 1980s. But as in the Reagan days, it must force the world to recognise the need to adjust. If America does not lead in global economic policy, no one else will. And if nothing is done, the imbalances will worsen and the dark scenarios of financial crashes or protectionism become ever more likely.

America's biggest contribution to shifting the world away from one-engined growth—and towards improving its own economic prospects—would be some serious medium-term fiscal belt-tightening. The country's dramatic shift into budget deficits may have underwritten the American, and thus the global, economy in the short term, but it risks making the medium-term problem much worse. Bigger American budget deficits mean bigger current-account deficits and an ever greater American reliance on foreign funding.

Worryingly, Mr Bush's deficits show no sign of being temporary. The president's tax cuts have not yet been fully phased in, and numerous accounting gimmicks have been used to massage down their apparent cost. The official estimate of the cost of the latest tax cut is $350 billion over ten years, but most budget-watchers put the real figure at twice that level. Nor is the government merely aiming to give the economy a temporary fillip; its declared intention is to reform America's tax code and entirely eliminate the taxation of investment income. That suggests there are more tax cuts to come.

**Spend, spend, spend**

Yet there is scant sign of any spending discipline to match the lower tax revenue. Despite his rhetoric to the contrary, Mr Bush has proved himself to be no Scrooge with federal dollars. On his watch, federal spending has soared by more than 20%. Only part of that rise can be explained by higher spending on defence or homeland security.

Defence spending, though, is heading ever higher, according to estimates by Steven Kosiak at the Centre for Strategic and Budgetary Assessments. He reckons that adding together Mr Bush's grand plans for military modernisation and existing commitments in Iraq and Afghanistan, the defence budget over
the next decade will increase by nearly $700 billion more than assumed in Mr Bush's budget projections.

And there is more. Mr Bush's planned expansion of Medicare, America's health-care programme for the elderly, to include prescription drugs, will supposedly cost $400 billion over the next decade. But most health-care experts—and privately some economists within the Bush administration too—expect the real bill to be much higher. Far from reforming America's entitlement programmes as baby-boomers head for retirement, Mr Bush is expanding them.

The risks of these policies have not gone unnoticed in Washington. Democrats have been bemoaning the rise in deficits a decade before the ranks of pensioners are due to swell. Still, it has all seemed a long way off. And yet if this survey proves right, America's budget deficit could cause big problems long before the baby-boomers start retiring.

American policymakers' main responsibility, therefore, is to improve the medium-term fiscal outlook. The budget rules that forced discipline on spending and tax-cutting plans during the 1990s must be revived. The Bush team must put forward detailed proposals for controlling Medicare costs. The spending frenzy must be controlled and the tax-cutting momentum slowed, perhaps even reversed.

If America acknowledged both the danger posed by global imbalances and its own responsibility for reducing them, putting political pressure on others to play their part would become much easier. In continental Europe, the pressure should be least necessary. For the policy recipe that is best for Europe is also best for the world economy: determined structural reforms coupled with a sensible (read looser) macroeconomic policy.

In Asia there is a greater tension between the short-term domestic agenda and what the world economy needs. China, as this survey has argued, must break the paralysis on its exchange rate and gradually move towards greater flexibility. To support that shift, the Bush team must beat back domestic China-bashers but keep up the pressure on the Chinese government for gradual change. At the same time China and America together must push other emerging Asian economies to follow suit.

In Japan, in the short term, the trade-off between domestic requirements and global responsibilities is even more difficult to judge. The global economy needs a stronger yen; the Japanese economy does not. But if the government were to begin serious financial-sector reform and simultaneously to reflate the economy, the contradiction would soon disappear, and the yen would strengthen without undue risk to the domestic economy.

If America shows the necessary leadership, and others live up to their responsibilities, there is still time to replace the one-engined global economy with a safer model. But if nothing changes, get ready for a crash landing.