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Global Imbalances, Bretton Woods II, and Euroland's Role in All This

By

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ABSTRACT

Approaching the issue of mounting global imbalances from the perspective of the “Bretton Woods II hypothesis,” this paper argues that the popular preoccupation with China’s supposed export-led development strategy is misplaced. It also suggests, similar to Japan’s depression, subdued growth in Euroland for most of the time since the Maastricht Treaty has been of first-order importance in these developments. Germany is identified as being at the heart of the European trouble. Globally, there is an ongoing clash between two approches to macroeconomic policy making: a highly dogmatic German approach, and a very pragmatic Anglo-Saxon one. The low levels of interest at which global demand imbalances have been smoothed out financially reflect deficient global demand in an environment of vast supply-side opportunities. After contributing greatly to the build-up of imbalances, Euroland is unlikely to play any constructive part in their unwinding. Hampered by an exchange-rate policy vacuum, a small-country mindset, and soaring intra-area imbalances, Euroland is also illpositioned to cope with fading external growth stimuli.

JEL Classifications: E63, F02, F32, F43, N10

Keywords: Global Imbalances, Revised Bretton Woods, EMU, Divergences, Export-led Growth, Reserve Currency

1. INTRODUCTION

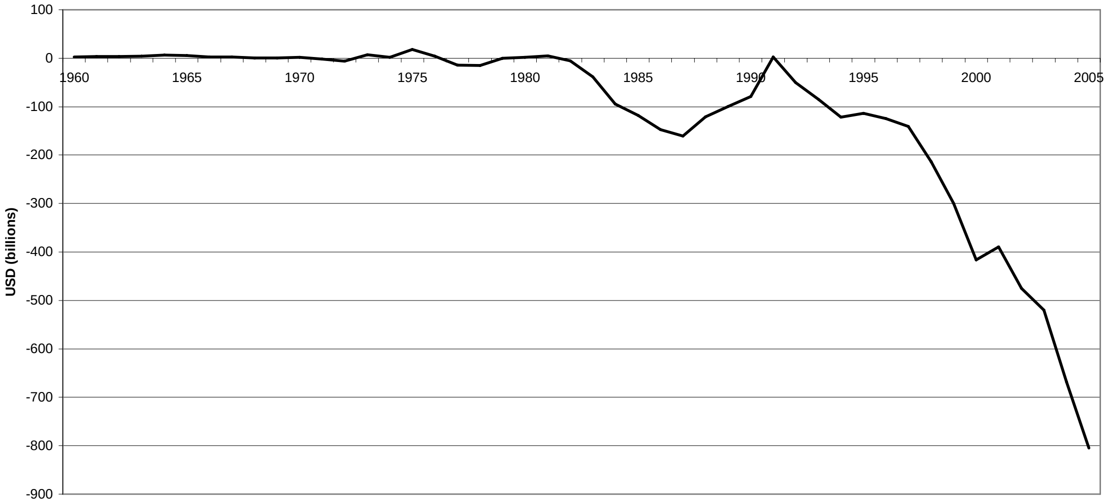
Approaching the issue of mounting global imbalances through the angle of the “Bretton Woods II hypothesis” (BWII), this paper sets out to investigate Euroland’s role in particular. It is argued that popular preoccupations with the UnitedStates’s “twin-deficit” and China’s “beggar-thy-neighbor” (renminbi undervaluation) only scratch the surface of what really are the consequences of a rather complex set of causes and developments. Systemic deficiencies in the global monetary order that induce the developing world to run current account surpluses and accumulate dollar reserves is one factor. Japan and Germany’s protracted domestic demand stagnation another. Germany’s key role somehow disappeared with the shift in focus on Euroland as a whole, and Euroland’s role, in turn, was written out of the play when the oil price boom turned the area’s current account surplus into a small deficit. It is erroneous to ignore the global ramifications of protracted domestic demand stagnation in an economic area similar in size to the United States. Just as it is hypocritical to bark at China’s external surplus, which really only attained a globally significant role over the last couple of years—while the U.S. external deficit has built up continuously since the early 1990s.

The analysis begins with a look at some internal trends in the United States related to its soaring external deficit. After introducing BWII in section 3, the analysis turns to the “trade account region” and some prominent surplus countries in section 4. Section 5 discusses U.S. macroeconomic policy pragmatism, the U.S. dollar, and “benign neglect.” Section 6 then focuses on Euroland’s role in the global context. Section 7 concludes.

2. MOUNTING GLOBAL IMBALANCES

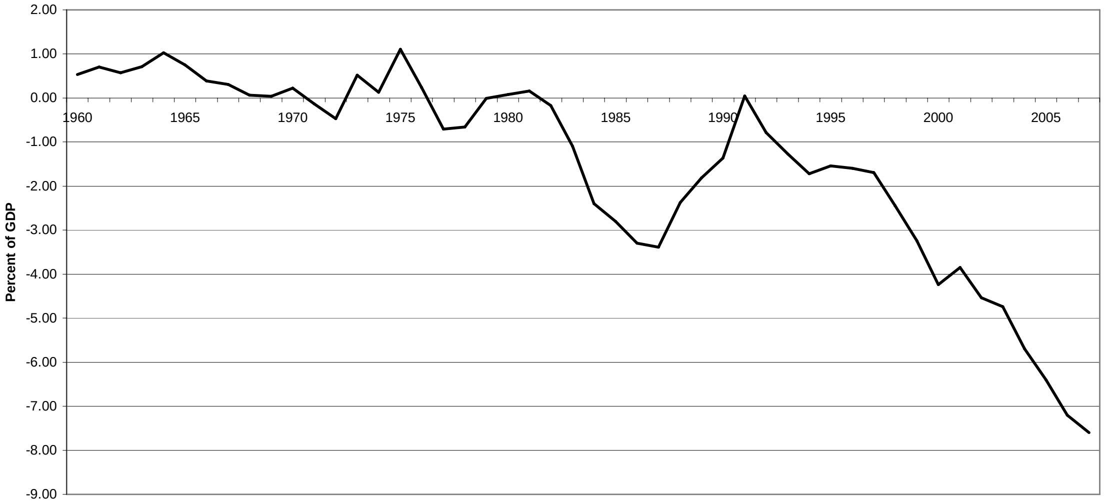
Debate about global imbalances generally focuses on the U.S. current account. Since 1991, when, for once, the U.S. current account was in balance, it has deteriorated persistently, both in absolute terms and as a share of GDP, reaching USD 200bn (or 2.5 percent of U.S. GDP) by 1998, USD 400bn (or 4 percent of U.S. GDP) by 2000, USD 655bn (or 5.5 percent of U.S. GDP) by 2004, and USD 805bn (or 6.4 percent of GDP) last year (see figures 1 and 2). The latest OECD (OCED 2006) projections show a continuing rise in the deficit to 7.6 percent of GDP by 2007.

Figure 1. U.S. Current Account Balance: 1960-2005



Source. EcoWin/Reuters

Figure 2. U.S. Current Account Balance: 1960-2007



Sources. EcoWin/Reuters, OECD Economic Outlook no. 79 for 2006-07 forecasts

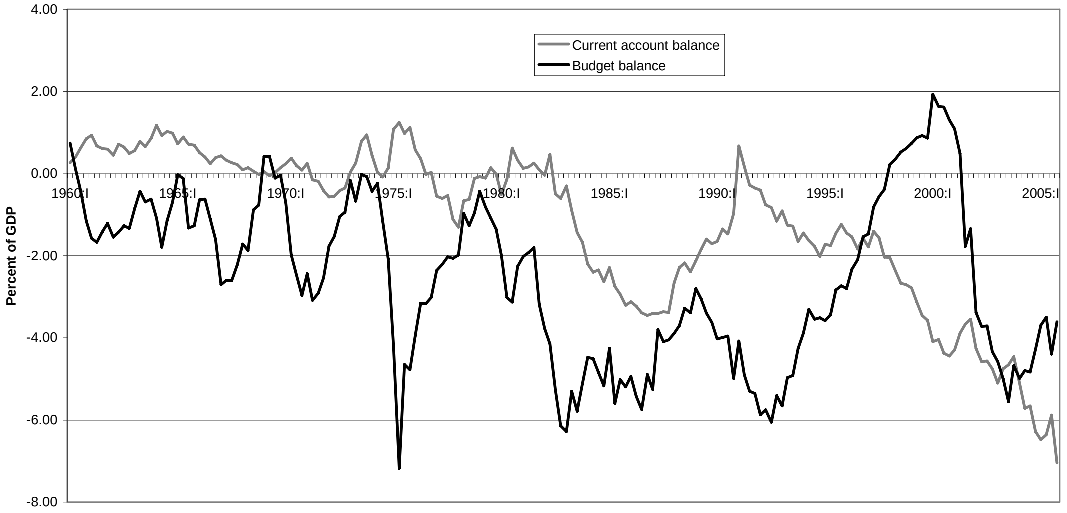
In line with the various macroeconomic meanings of the current account, commentators either emphasize that U.S. domestic investment exceeds national saving (with foreign saving filling the gap), that U.S. domestic demand outstrips U.S. production (with imports filling the gap), or that U.S. net foreign investment is sharply negative and the rest of the world accumulating, in one way or another, ever more claims against the United States (Godley 1995; Godley, Papadimitriou, and Zezza 2006; Papadimitriou, Chilcote, and Zezza 2006).

As to the causes, commentators either stress that the United States is apparently saving too little and spending too lavishly, that the rest of the world is all too keenly exporting to, but less eagerly importing from, the United States, or that for some reason foreigners just indulge in investing in and lending to the United States. On the first view, the spendthrift United States is the clear villain behind the whole unbalanced situation. On the second view, trading partners play somewhat more of a role, too, in either refusing to grow faster and/or become less competitive and import more from the United States. On the third view, the imbalance is not so much a saving or trade matter, but instead driven by finance and capital flows in the first place, with foreign investors, presumably in search of higher returns, piling their money into what would seem to be the world's premiere investment location.

No doubt the first view is especially popular in Europe, where policymakers and commentators alike tend to be awed by the U.S.'s apparent fiscal irresponsibility. Reviving a theme much heard of during the 1980s, too, U.S. fiscal profligacy is seen as the root cause of today's global imbalances—the so-called "twin deficits" are back. Even more so than during the 1980s, when Germany alone was trying its luck with "expansionary fiscal contraction," meanwhile convinced by that idea much of Europe is today saddled with a "balancing-the-budget-no-matter-what" mindset, the spirit of which was grafted into the Maastricht convergence criteria and the "Stability and Growth Pact."[1] To the German/European mindset, then, the twin deficit idea is a very appealing explanation of today's global imbalances.

[1] Cooper (2005) noted: "my impression is that the consensus view among American economists is that fiscal stimulus (a reduction in taxes or an increase in expenditures) will increase GDP in normal circumstances. My impression is that the consensus among German economists is that a fiscal stimulus will not increase GDP and

Figure 3. U.S. Budget and current account balances, 1960-2005



Source. EcoWin/Reuters

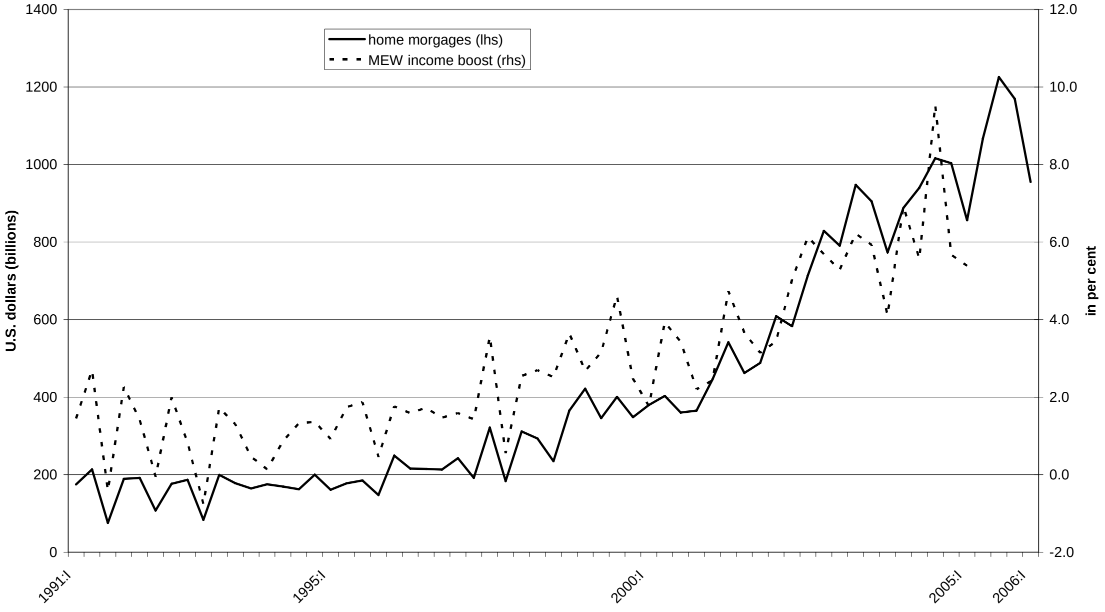
Empirically though, the twin-deficit theme does not stand on any firm footing. The correlation between the two deficit measures as a proportion of GDP is close to zero (see figure 3). In particular, just as the U.S.'s current account deficit began to soar in the mid 1990s, the U.S. budget deficit was actually disappearing, then even moving into surplus by the end of the decade. Again in 2004–5, as the U.S. budget deficit actually shrank, and to little more (as a percentage of GDP) than in supposedly virtuous Euroland, the U.S. current account deficit took yet another leap. While the twin deficit theme is, thus, something of a myth, Alan Greenspan's (2005) recent observation of a more stable long-term correlation between the U.S. mortgage market and the current account is of great interest.

The U.S. property price boom (or perhaps bubble) of recent years is one key issue here, boosting private consumption through corresponding wealth effects. The credit market phenomenon of "mortgage equity withdrawals" (MEWs) is another and potentially the more powerful one. Through relieving liquidity constraints, MEWs allowed mortgaging properties for the purpose of financing current expenditures. After gathering some strength in the second half of the 1990s, MEWs took off in earnest after 2000 in the context of the U.S. Federal

indeed may reduce it." Summers (2004) observed on Europe: "where policymakers too often confuse the supply and demand elements of economic policy."

Reserve's aggressive policy easing. As the Fed shaved some 550 basis points off its Fed funds target, this boosted bank profits and bond yields plummeted, igniting a huge "refi" (mortgage refinancing) boom (see figure 4). Lower interest rates allowed households to take on rising debt levels without increasing their interest burden correspondingly (Papadimitriou, Chilcote, and Zezza 2006). Only part of the additional borrowing actually ended up financing house purchases at rising house prices, thereby boosting construction. Another part—the home equity withdrawn—was used to supplement (weak) disposable income growth, thereby supporting general consumption expenditures (see Greenspan and Kennedy 2005; Goldman Sachs 2002, 2005, 2006).

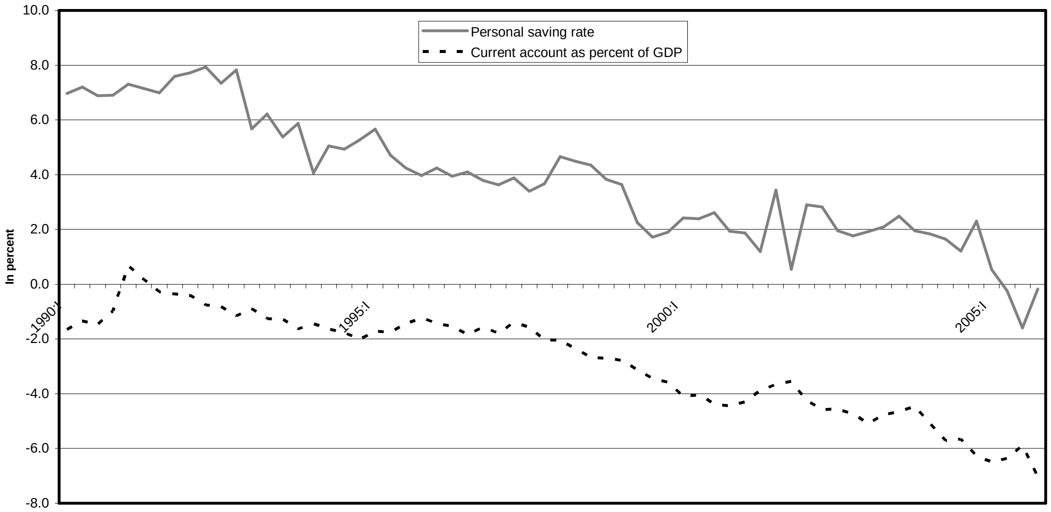
Figure 4. U.S. private households on a borrowing binge



Sources. FRB Flow of Funds Accounts, Greenspan and Kennedy 2005.
Note. "MEW income boost" shows net equity extraction as a per cent of disposable income.

In the process, the U.S. personal saving rate has declined markedly, dropping below zero by 2005. A rather neat correlation emerges here between U.S. personal saving behavior and the country's current account position, with the personal saving propensity, except for a mild upturn around 2001, on a continuous decline ever since the early 1990s (see figure 5).

Figure 5. U.S. Personal saving rate and current account



Source. EcoWin/Reuters

Of course a decline in personal saving as such does not necessarily lead to a current account worsening, as the latter reflects the overall constellation between national saving and domestic investment. The point is that in the second half of the 1990s, the United States also experienced a vigorous investment boom on top of the decline in the personal saving rate. U.S. private spending grew so strongly as to consolidate U.S. public finances on the way, and much more than that. Given foreign investors' keenness to invest in or lend their money to the United States, private capital inflows (in the form of both FDI and portfolio investment) were easily filling up the rising gap between U.S. domestic demand and production.

This situation ended with the bursting of the dot-com bubble and tanking of the U.S. economy after the spring of 2000. As net foreign direct investment inflows turned negative and portfolio equity investment also dried up at times, "official lending" came to play a key role in financing the U.S. balance of payments deficit. The shortfall in private capital inflows into the United States after 2000 would seem to put to rest the view that international finance, rather than trade, lies behind the country's soaring current account deficit. But the hypothesis was then put forward that official flows would just as well qualify as a candidate driving force behind these seemingly unbalanced developments.

3. THE BRETTON WOODS II HYPOTHESIS

Dooley, Folkerts-Landau, and Garber (2003) deserve credit for highlighting that current account imbalances are inherently a two-sided affair. It makes little sense to focus on the U.S. current account deficit and ignore that there must be corresponding surpluses elsewhere in the world economy. In fact, the three authors argue that surplus-seeking countries are the ultimate driving force behind the imbalance and that the whole situation, which they refer to as the "revived Bretton Woods system" (BWII, for short), may be far less unstable than it might seem at first. In their view, the situation is sustainable since it brings mutual benefits to both the peripheral surplus countries, as well as to the deficit country at the center.

In a nutshell, BWII states that certain developing Asian countries are today adhering to the same export-led development strategy that was followed by Western Europe and Japan a few decades ago (namely under Bretton Woods I). With the United States today reinstalled as the "center country" issuing the reserve currency and providing financial intermediation services to a new "periphery," the dynamic structure of the global monetary system since the advent of Bretton Woods has remained essentially the same; except that new players have substituted the previous periphery generation since its graduation to the center.

The periphery's export-led development strategy features: an undervalued exchange rate that yields net outflows of goods to the center, capital controls to protect the peg, and official capital outflows that involve the accumulation of reserve asset claims on the center. The relevant peripheral countries form the "trade account region" whose main concern is exporting to the United States since "exports mean growth." According to BWII: "When the [trade account region's] imports do not keep up, the official sectors are happy to buy U.S.

securities to finance the shortfall directly, without regard to the risk/return characteristics of the securities. Their appetite for such investments is, for all practical purposes, unlimited because their growth capacity is far from its limits." Meanwhile, the dollar foreign exchange reserves accumulated along the way serve as collateral for the growing stock of foreign direct investment in countries whose own financial structures are as yet underdeveloped.

While the United States is the premiere intermediary of the system on this view, there is also a "capital account region" of countries that are characterized by a developed financial system and flexible exchange rates. This region includes Europe, Canada, Australia, and most of Latin America. Since it is not this region's official sector, but its private investors who presumably care about the risk/return of their international investment position, the capital account region is not an unlimited abode of claims on the United States. Continuously reassessing their U.S. exposure, private investors are the key driving force behind net private capital flows and exchange rate movements between the U.S. dollar block (including the periphery) and currencies issued by the capital account region, while official capital flows between these two zones play no role.

BWII paints an illuminating picture of a world of unequal players that seems to have matched the situation in 1997–2003 rather well. During the "new economy" boom, private investors in the capital account region keenly raised their U.S. exposure, driving the dollar up against the euro, for instance.[2] As their keenness subsequently tired and they rolled back their U.S. exposure, the euro appreciated again. At that point, the trade account region's official sectors stepped in to refill the shortfall left thereby, so as to maintain their exchange rate pegs—and exports to the United States (see also Higgins and Klitgaard 2004).

Can we conclude here that global imbalances are a sign of good health and the BWII system sustainable? Is the trade account region really bound to underwrite the United States in

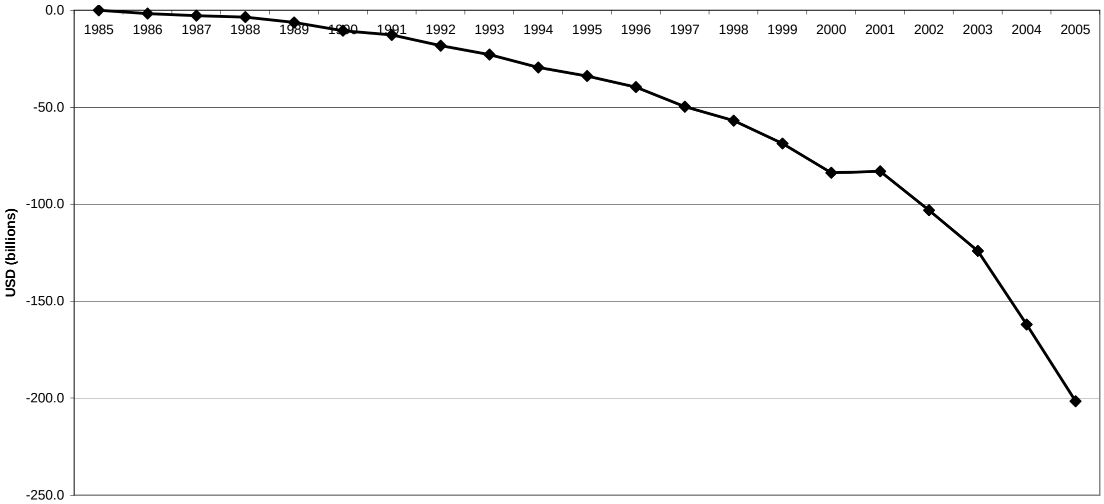
[2] Bibow (2002) argues that the ECB did its best to scare private investors, both through its confused communications and transparently growth-unfriendly interest rate hikes in this period.

the long term? It seems to me that the BWII hypothesis provides a rather partial description of the underlying global constellation. As the U.S. current account deficit today extends to almost the rest of the world and, thus, includes countries that would seem to make rather strange bedfellows as members of the trade account region. The role of the supposed capital account region—featuring Euroland—in today's global system and constellation of global imbalances remains somewhat under explored.

4. A CLOSER LOOK AT THE TRADE ACCOUNT REGION AND SOME KEY SURPLUS COUNTRIES

Being the most obvious trade account region candidate, China is the second focal point in the debate on global imbalances. Certainly commentators in the United States tend to see China as the root cause of the U.S. current account deficit since, on a *bilateral* basis, the U.S. trade deficit with China has truly surged since the mid 1990s, exceeding $200bn by 2005.

Figure 6. The growing US-Chinese trade imbalance, 1985-2005



Source. EcoWin/Reuters

However, only after 2002 has China's overall current account position really moved sharply into a *globally* significant surplus position, attaining $68.7bn by 2004 and surging to $158.6bn (or 7.1 percent of GDP) by 2005 (IMF 2006).

Does this then prove that China pursues a beggar-thy-neighbor policy, and what does export-led development mean anyway? A first important fact not to be overlooked in this context is China's very fast domestic demand growth. Filipe and Lim (2005) find that over the 1993–2003 period, net exports contributed to less than ten percent of overall GDP growth. In particular, domestic demand contributed 8 percent annually to GDP growth between 1999 and 2002, while net exports were a minor drag, according to the IMF (IMF 2003). While domestic demand growth has accelerated thereafter, export growth accelerated even more; whereas import growth decelerated somewhat of late. China's WTO entry in 2001 may be one factor behind this. The renminbi's depreciation since 2002 in line with the dollar is perhaps another; although this also reminds us of its prior appreciation in line with the dollar between 1995 and 2001 (withstanding the Asian crises). But exceptionally high productivity growth in manufacturing seems to be the key factor behind China's export performance. Sharply decreasing unit labor costs are boosting external competitiveness, while nominal wage inflation is in line with nominal GDP growth (UNCTAD 2005).

China's persistently strong domestic demand growth contrasts sharply with Germany's situation—another candidate for export-led growth. Whereas stagnant Germany features growing trade surpluses vis-à-vis its European partners, China actually runs deficits vis-à-vis some of its Asian neighbors. Reflecting an increasing degree of trade integration in the region, China has become a premiere location for final assembly of manufactures. Given its size, China is an extraordinarily open economy and really the "bazaar economy"[3] par excellence

[3] Sinn (2005) claims that Germany has no real title to be export world champion as an increasing share of its exports are no longer "made in Germany" but imported from elsewhere. A look at the growth contribution of *net* exports pays put to the bizarre "bazaar economy hypothesis"; yet another variation on the theme that Germany cannot grow because of its alleged structural problems, and as such, is instrumental in the deflationists' agenda.

today. Export-led development does not require export surpluses, only export revenues that are sufficient to prevent any constraint on imports from arising without recourse to foreign borrowing. Deliberately seeking export surpluses may be seen as a cause of imbalance. Yet, if China is seen as a main culprit of current account imbalances, this is a recent development. For until 2002–03 its role was quantitatively of third-order importance only. By contrast, the U.S. current account deficit has gradually built up since the early 1990s.

Accordingly, until 2002, China's foreign exchange reserve accumulation was mainly the counterpart to FDI inflows—as BWII suggests. This has changed drastically in recent years, when surging current account surpluses, as well as accelerating FDI and non-FDI capital inflows, have contributed to a rapid build-up in China's reserve holdings (reaching $1tn in 2006). At the same time, the People's Bank of China was seen issuing huge amounts of debt securities (in addition to increases in minimum reserve requirements of banks and other measures) to mop up the resulting domestic liquidity.

BWII interprets this constellation as reflecting China's pursuit of a deliberate policy of renminbi undervaluation to boost growth and employment via exports. At ten percent annual GDP growth, consumer price inflation has stayed very low up to this point despite soaring commodities prices. Asset price inflation and regional property markets, on the other hand, are giving rise to some concern. Many observers, thus, question the wisdom of China's policy regime focused on the U.S. dollar (see Roubini and Setser 2005; Goldstein and Lardy 2005, for instance). They suggest that an immediate and sizeable renminbi revaluation would be in China's own best interest.

I am not convinced. China's stronghold in international trade stems from still low (although rapidly rising) wages and declining unit-labor costs, the latter owing to exceptionally high productivity growth in manufacturing. To counterbalance this advantage through the nominal exchange rate would require a very sizeable renminbi revaluation indeed. A gradually appreciating renminbi may be preferable though. The risks to China and the world related to any drastic revaluation today appear significant given that other sectors (banking and agriculture in particular) seem far more vulnerable.[4]

Reducing China's very high saving rate and boosting domestic demand seems more promising. High personal saving is a reflection of China's underdeveloped financial and social security systems, and recent reform initiatives by the Chinese authorities specifically target the latter—to reduce precautionary saving. Reforms along these lines should lead to rising imports and a refocusing of investment towards local consumption rather than exports. High public saving leaves scope to boost disposable incomes today, especially in rural areas, and it may also provide a welcome lifeline to Asia when the next recession hits (as in the wake of the Asian crisis). Through such a rebalancing of demand China will gradually cease to act as a seemingly unlimited abode of reserve asset claims on the United States.

It is far less clear that the Asian NIEs and emerging Asia at large properly qualify for the trade account region in the BWII sense (see Kamin 2005). Recall here that—following financial liberalization—the "Asian tigers" experienced rising current account deficits in the pre-crises years. The crisis of 1997–98, which presented a severe disruption in the region's development and memories of which are still fresh, then caused a severe slump in investment and involved sharp exchange rate depreciations that boosted external competitiveness and led to a drastic swing in current account positions in the region. Relying on export growth to overcome subdued domestic demand growth and deflationary pressures, the region has been eager to prevent renewed exchange rate overvaluation ever since. China was, thus, not alone in the region in intervening in foreign exchange markets and accumulating reserves in the process. Yet, while the U.S.-Chinese imbalance has surged, the United States' overall position with the region worsened by far less, as the U.S. trade imbalance with some other countries in

[4] China's exchange rate regime was officially changed on July 21, 2005. Since then, the renminbi has gradually appreciated from its long-standing 8.28 peg rate by some four percent against the U.S. dollar. The declared policy is to gradually make the regime more flexible. Using the Oxford Economic Forecasting model, Park (2005) shows that a 20 percent renminbi revaluation vis-à-vis the U.S. dollar would reduce the U.S. current account deficit by a mere 0.05 percent of GDP while risking a hard landing for the Chinese economy.

the region actually shrunk. Also, in line with economic recovery, some Asian currencies (the Korean won in particular) appreciated against the dollar in 2005. Overall, rather than being strictly in line with their supposed trade account role, the regions' behavior probably owed more to the 1997–8 regional crisis and renewed slump in 2001.

Financial turbulences and crises have been widespread in the developing world in the era of financial liberalization. Rodrik (2005) noted a common trend towards rising foreign exchange reserve holdings in developing countries since the early 1990s. Reminded again and again that sudden reversals in capital flows can cause severe economic disruptions, countries seem to seek protection primarily through increased liquidity. To an extent, this is a financial intermediation process for which developing countries pay a handsome insurance premium (the spread of their international borrowing costs above U.S. T-bill rates). Through running current account surpluses, they safely add to their liquid (net) foreign assets. Summers (2006) referred to this phenomenon as the "global capital flows paradox."[5] Arguably, building up a protective shield against financial crises whilst relying on export earnings (rather than foreign saving) for growth reflects developing countries' response to systemic deficiencies in the global monetary and financial order.

A truly odd de facto member of the trade account region is Japan, which according to BWII, has long graduated to the core. Yet, Japan featured prominently among countries that heavily intervened in U.S. dollar support in 2002–04, accumulating foreign reserves on a massive scale to contain the yen's appreciation. Keeping the yen competitive should best be seen in the context of the Bank of Japan's "quantitative easing" policy that flooded Japan's fragile banking system with liquidity ("à outrance," as Keynes advised in his Treatise) in an endeavor to escape from deflation at zero interest rates. Even more so than other Asian countries following the 1997–98 regional crisis, Japan probably considered relying on export

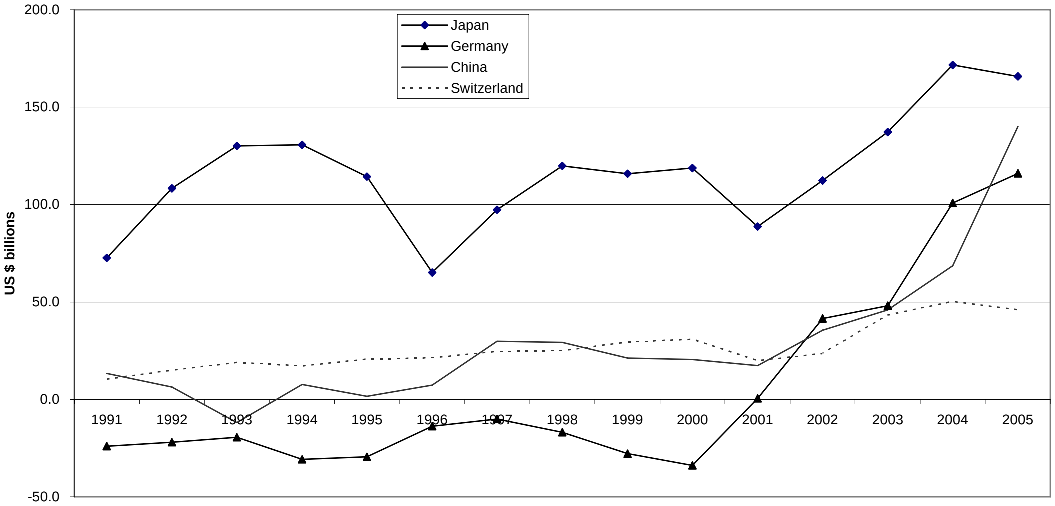
[5] The new EU member states and potential future EU entrants are an exception to this global phenomenon.

growth as its best bet to end its long depression. Japan's bilateral trade surplus with the United States increased from $50bn to $80bn between 1995 and 2000, but has not changed much since then. By contrast, after fluctuating between $70bn and $120bn from 1991 until 2002, Japan's notorious current account surplus position has since increased to $160–170bn. In line with its strong international creditor position, this is mainly due to surging investment income.

There are some remarkable parallels between Japan and Germany, respectively the second and third largest economies in the world, as Germany, too, has experienced a persistent slump in investment and protracted domestic demand weakness since the early 1990s. By contrast, both countries grew strongly in 1991, when the U.S. current account was last in balance. Figure 7 [6] shows that among today's current account surplus countries, Germany has seen the biggest absolute change in its external position since 2000—by some $145bn!

Figure 7. Countries with huge current account surpluses

Largest swing since 2000 occurred in Germany



Quelle. OECD Economic Outlook no. 79, (Jun 06)

[6] As a tribute to the host country of the Lugano conference, Switzerland was included, too. Another advanced economy that has gone through a prolonged period of subdued growth since the early 1990s, Switzerland's current account surplus is among the highest in the world in relative terms (13 percent of GDP) and quite significant in absolute terms, too ($46bn in 2005).

Suffice to mention here that current account imbalances have been markedly exacerbated by the oil price boom since 2004. One effect was to add yet another $100bn or so to the U.S. deficit, another was to redistribute current account surpluses away from Euroland and other oil importers toward oil exporters. While the group of oil-exporting countries is diverse (featuring Saudi Arabia, Russia, Norway, Nigeria, Venezuela), their combined current account surplus position has improved by around $300bn since 2002. Global payments imbalances would shrink if either oil prices reversed or spending propensities adjusted in line with the global income redistribution caused by this terms of trade shock.

In conclusion, the widespread focus on China is understandable at first sight given that, on a bilateral basis, the country has the largest share in the U.S.'s trade imbalance. Yet China's contribution to global imbalances was quantitatively insignificant until recently—between 1994 and 2002 China's current account surplus averaged $20bn, less than Switzerland's. While China matches the BWII description of the trade account region, at least in some respects, other Asian economies do not. The region at large seems to have relied on export-led growth primarily as an emergency strategy to overcome domestic headwinds stemming from the 1997–8 regional crisis. In fact, a more general trend seems to be underway in the developing world to pay down external debt and accumulate U.S. dollar reserves as a protection against financial crises whilst relying on export-led growth.

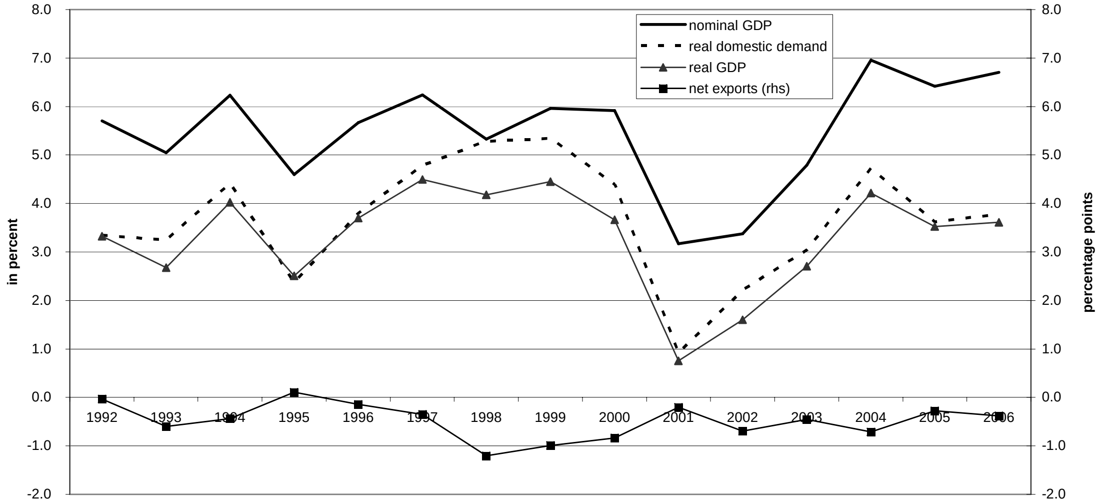
BWII completely fails to account for some key industrial countries. Together Japan, Germany, and Switzerland, the world's premiere laggards, make up some 40 percent of the size of the U.S. current account deficit. Moreover, oil exporters' lagged spending response to their terms-of-trade gains since 2004 have exacerbated and redistributed global payments imbalances; in the process of which Euroland's external surplus position has turned into a small deficit, for instance. In short, today's global constellation of current account surpluses is far more diverse, also with respect to its underlying causes, than BWII suggests. It is now time to explore the core’s role.

5. MACROECONOMIC POLICY PRAGMATISM AND BENIGN NEGLECT AT THE CORE

According to BWII it is natural for the core to play by a different set of rules. As issuer of the world’s number one reserve currency, the United States can finance current account deficits at ease as long as its creditors are satisfied with accumulating claims on future U.S. production—*in U.S. dollars*. So the United States can happily live beyond its means for much longer and without facing the kinds of problems that other debtor countries would normally have to fear. Some key facts about the evolution of the U.S. current account position and certain striking internal (counter-part) trends since the early 1990s were described in section 2 above. Here we need to highlight the key role of macroeconomic policy pragmatism behind the remarkable stability and strength in U.S. GDP growth since 1992, except for the two-year pause in 2001–02.

Figure 8. The U.S. as global growth engine

Featuring persistent net exports drag



Source. OECD Economic Outlook No. 79 (Jun 06)

The United States’ impressive overall GDP growth performance (see figure 8) was achieved while significant shifts in its composition occurred. The only stable trend throughout this period was the continuous decline in the personal saving rate that accompanied strong and stable consumption growth. Investment, by contrast, has seen boom (1996–2000) and bust (2001–02), followed by gradual recovery since 2003. One might have expected the gap between U.S. saving and investment to narrow with the 2001 recession. Just at that time though, a swing in fiscal stance occurred that turned a budget surplus of 1.6 percent of GDP in 2000 into a deficit of 5 percent of GDP by 2003. By luck or design, the fiscal swing was not only of unprecedented magnitude, but also well timed—filling the gap in demand left by insufficient corporate investment. Fiscal expansion received great support from the Fed’s fast-track monetary policy easing since 2001, together crowding *in* private spending (both in the United States and elsewhere) as the Fed’s pre-emptive strike at deflation led the way to historically low interest rates, which boosted U.S. property prices, construction, and consumption spending.

Externally, the “new economy” boom was accompanied by a “strong dollar” policy, which was but one aspect of the U.S.’s benign neglect of its deteriorating trade position accompanying the flexible and pragmatic use of macroeconomic policies. In fact, the internal and external dimensions of U.S. policy are intimately related. Applying macroeconomic policies to sustain GDP and employment growth in the United States *meant* tolerating significant policy spillovers from U.S. domestic demand growth to other regions in the world, regions that for various reasons were having trouble boosting their own domestic demand and, thus, primarily relied on export growth instead.

BWII suggests that the dollar’s status in today’s global monetary order provides the motivation for the U.S.’s benign neglect of its deteriorating trade position. Analyses of the international role of a currency focus on monetary functions and the seignorage gains that stem from the international use of a currency for these purposes. A narrow interpretation of (international) seignorage estimates the central bank profit on that part of the note issue that circulates abroad. A broader interpretation includes certain benefits from trade invoicing in the international currency (for instance, oil) and certain home advantages of financial institutions. Arguably, the real issue is best illustrated by the fact that the United States' net flow of investment income has stayed positive until 2005 despite a sizeable negative net international investment position (with liabilities exceeding assets by some $2.5 trillion). For this to be possible, "the United States" must be a rather profitable financial intermediary indeed. The United States as a nation must hold sufficiently profitable items among its gross foreign assets, the return on which over-compensates its net debtor position (amounting to some 25 percent of GDP).

The U.S.'s "exorbitant privilege" just described is mainly of two kinds. One source stems from the higher yields the United States gets on its foreign assets compared to what it pays to foreigners on its liabilities. The favorable yield premium reflects the asset structure of the U.S. balance sheet and owes to a number of factors like, for instance, the liquidity of U.S. Treasury securities markets and risk premia on the U.S.'s equity and direct investments abroad. Gourinchas and Rey (2005) describe the United States as the world banker that has turned into world venture capitalist. The attractiveness of U.S. Treasury securities is inherently related to the U.S. dollar's international status.

The other source of the United States' advantage arises from valuation effects and is directly related to the dollar's status, too. While the United States holds a share of 70 percent of its foreign assets in foreign currencies, its borrowing is all in U.S. dollars. Dollar depreciation, thus, involves wealth transfers from the rest of the world. In fact, the greater the financial leverage in the U.S.'s gross international investment position, the greater the valuation gains obtainable in this way—a kind of "original virtue" effect.

The U.S.'s exorbitant privilege can either be based on the financial account only, with the United States financing its high-yielding foreign investments through currency note issuance and other low-yielding Treasury securities while the current account remains in balance—as under Bretton Woods I. Or the dollar can be leveraged through building up a net debtor (and hence short dollar) position by running current account deficits—as under Bretton Woods II. When viewed as an "on-going business," the yield advantage helps to offset any trade deficit while valuation gains partly erase the U.S.'s external debts (see Cavallo and Tille 2006).

While this privilege may be significant, or even exorbitant, it is neither unlimited nor does it negate the laws of arithmetic, which imply a sharply rising external-debt-to-GDP ratio. In particular, net investment income (i.e., U.S. financial intermediation profitability) is unlikely to improve as the Fed boosts Treasury yields.[7] Also, the prospect of recurrent dollar depreciation might damage the dollar's status and attractiveness, risking disorderly business. Higher U.S. GDP growth, per se, would alleviate the burden of the debt, but GDP is also the driver of U.S. import growth. In fact, a U.S. recession, together with a falling dollar and oil price, is the surest way to reduce global imbalances—but the rest of the world might then regret what it was wishing for.

Perhaps we should not worry too much but hope, as BWII suggests—depicting the international role of dollar liquidity rather well—that the symbiosis between the United States and its debtors might last for quite a while longer. However, given the magnitudes of imbalances reached by now this seems an optimistic proposition since the United States may have become over burdened as global growth engine number one.[8]

The United States' role as global growth engine number one is reflected in Figure 8 above in the gap between domestic demand and GDP growth. Especially during the period from 1996 until 2000 and again since 2002, domestic demand outpaced GDP growth by a large margin. This enormous stimulus to the world economy owes to an ongoing focus of U.S.

[7] Note that portfolio shifts out of lower-yielding into higher yielding U.S. assets would shrink the privilege, too.

[8] See the Levy Institutes' periodic *Strategic Analyses* on this, Godley et al. 2005, for instance.

authorities on full employment at price stability paired with benign neglect on the external front. The cumulative effects of this truly benign neglect have manifested themselves in a U.S. current account deficit which represents a two-per-cent-of-GDP impulse to global aggregate demand—to which the rest of the world has become addicted.

The United States' accommodating role as to weaknesses elsewhere in the world economy was noticed by Henning (2000), for instance, who observed that almost $100bn of the rise in the U.S. current account deficit from 1996 to 1998 was a consequence of allowing Asian and other crises economies to see their current account positions turn into surplus. Interestingly, Henning went on to observe that "American policy-makers were clear about their desire for Europe to join in this process. … But rather than contributing to the adjustment, the euro area *increased* its surplus over the same period" (Henning 2000).

From early on, the IMF, too, stressed the role of Europe and Japan in the build-up of global imbalances. Referring to the rise in the U.S. current account deficit of 1.5 percent to nearly 4.5 percent between 1995 and 2000, the Fund observed in its May 2001 World Economic Outlook that "rapid U.S. GDP growth and relatively weaker growth in other parts of the world, notably Europe and Japan, as well as a sharp increase in the real foreign exchange value of the U.S. dollar driven in large part by capital inflows, contributed to the rise in the deficit. The domestic counterpart has been a significant rise in investment" (IMF 2001). In September 2002, the Fund observed that "external imbalances across the main industrial country regions widened steadily during the 1990s" (IMF 2002), with these imbalances being "dominated by the euro area and Japan, respectively" (IMF 2002).

In September 2005, the Fund then highlighted a wider dispersion in current account imbalances: "Between 1997 and 2004, about two-thirds of the increase in the U.S. current account deficit has been balanced by higher external surpluses in emerging market and oil-producing countries, with the rest matched by larger surpluses in industrial countries (mainly

Japan)" (IMF 2005). In its April 2006 World Economic Outlook, it observed that "The U.S. current account deficit has continued to rise, matched by large surpluses in oil exporters, China and Japan, a number of small industrial countries, and other parts of emerging Asia" (IMF 2005). Note, then, that Euroland's role has been silently written out of the play. Despite running the largest trade surplus in the world and after experiencing the largest current account swing in absolute terms, Germany does not even get mentioned among surplus countries either anymore. Time to scrutinize the apparent nonrole of Euroland.

6. EVER BECOMING PART OF THE SOLUTION RATHER THAN BEING PART OF THE PROBLEM?[9]

As a "grown-up" member of the capital account region, its natural home according to BWII, Euroland has essentially faced a choice between two strategies. The first features a primarily inward-oriented macroeconomic policy stance that aims at full employment at price stability, combined with a balanced external position. As suits a large and fairly closed economy, GDP growth would be solely driven by domestic demand and be in line with potential growth, too. For an economy that aspires to be a global economic player and reserve currency issuer, a second strategy may be even more suitable. This strategy also features a macroeconomic policy stance aiming at internal balance, but joined by benign neglect as regards external balance. With the euro as a true rival to the dollar, by more than aspiration, in today's global monetary order, Euroland would share the benefits that the United States has so far reaped alone.

[9] Credit is due here to Michael Mussa, who vigilantly observed that the ECB was at the heart of the problem from early on. On April 29, 2001, the then IMF chief economist attested that "it is time for the ECB to become part of the solution, not part of the problem, of slowing global growth" (Beattie and Fidler 2001a). Exemplifying the ECB's single-minded and backward-looking focus, Mr. Duisenberg explained that "with inflation above the central goal, a move in interest rates in that context would not enhance the credibility of the ECB" (Beattie and Fidler 2001b). It is doubtful whether this peculiar mindset, which continues to inspire the ECB's conduct until today, has really enhanced its credibility. Surely it is not all that conducive to growth and employment though.

In actual fact, however, Euroland has chosen not to follow either of these strategies. Instead, Euroland has de facto behaved more like yet another member of the trade-account region. One reason for this failure is that it is not all that clear what Euroland's aspirations really are, an issue on which the following observations by imminent policymakers or scholars shed some interesting light. According to Padoa-Schioppa (2004, p. 139), "the Economic and Monetary Union was not conceived to address an external challenge. The challenge was rather intra-European … the euro came to life without program, ambition, or doctrine for its international role." By contrast, Charles Wyplosz (1997) identified "the international role of the euro [as] the hidden agenda of Europe's long-planned adoption of a single currency." Finally, Henning (2000) diagnosed that: "EMU is in part a defensive reaction against U.S. monetary diplomacy, as it unfolded over the postwar decades. EMU shields the euro area from some of the disruptive effects of dollar fluctuations."

Although these assessments would seem to contradict each other, there is truth in all of them. Just like its EMS forerunner, the euro was intended to protect Europe—as an "island of monetary stability"—against external shocks. By integrating Europe at the monetary front, a key hope was that an internally stabilized Europe would then be in a better position to withstand disturbances originating "elsewhere in the world economy." While this motivation is well in line with strategy one above, hopes that the euro would make Europe more equal to the United States and give it more weight globally were always present, too. De Gaulle is famous for complaining about the U.S.'s "exorbitant privilege,"[10] which would speak for strategy two above. In light of these motivations, it seems truly puzzling that Padoa-Schioppa is quite right in attesting a lack of any "program, ambition, or doctrine" supporting the euro's international role as it was actually designed in the Maastricht regime of EMU.

[10] Gourinchas and Rey (2005) attribute this position to Valéry Giscard d'Estaing, one of the founding fathers of the European Monetary System (EMS).

For the Maastricht regime *is* institutionally introverted and incomplete with regards to the projects' external dimension. The foremost issue here concerns external representation and responsibility for exchange rate policy in EMU. But in comparison to the U.S. dollar, the euro's lack of a fiscal backing and related financial system shortcomings, such as the absence of a lender-of-last-resort for Euroland and nonexistence of a Euroland Treasury bill traded in a deep and liquid market, are rather serious systemic deficiencies, too. Not only do these shortcomings handicap the euro's potential global role, they also dilute the euro's supposed function as a protection shield against external disturbances.

The Maastricht regime's deficiencies were no accident though, but deliberate, reflecting "Bundesbank wisdom."[11] Essentially, Germany's famously independent central bank was determined to replicate German monetary and exchange rate arrangements at the European level. If anything, the European arrangements to be established had to be even more "prudent" than Germany's, and aspects which had complicated the Bundesbank's position in the past had to be corrected. Exchange rate matters had featured prominently as a cause of conflict in its history. For in this field, too, the Bundesbank was in an atypically—by international standards—strong position vis-à-vis the government. Yet, to take exchange rate policy completely out of political control in the Treaty would have been an unrealistic aim. So leaving things open de jure provided the ECB with the greatest possible latitude to establish its de facto leadership through practice and negotiation. A de jure vacuum would tilt the balance of power in favor of (the supposedly united front of independent) central bankers and against (less united and probably insufficiently coordinated) finance ministers. Apart from asserting its "natural competence" in financial market operations, including foreign exchange

[11] The Bundesbank's decisive role in designing the Maastricht regime is well known. Dyson and Featherstone (1999) provide a thorough account of the negotiations that led to the Treaty and the national dispositions that inspired them. Essentially, Helmut Kohl could only steer Germany into EMU by getting the Bundesbank aboard. For Germany's European partners, getting rid of German monetary hegemony required accepting a policy regime based upon Bundesbank wisdom (though under shared "control").

markets, the ECB can use public relations to denounce finance ministers' aspirations as an attack on its independence; a strategy that used to work rather well for the Bundesbank.

Other relevant Bundesbank views concerned short-term public debt instruments and any explicit lender-of-last-resort responsibilities, paired with a general reluctance concerning the DM's international role. For if a Euroland Treasury bill were to facilitate easier external financing of public debt this would be wholly undesirable; a Euroland equivalent to the U.S. Treasury Department a sheer nightmare. Establishing watertight protection of the ECB's independence and stability orientation "above all else" was the overriding issue.

It is debatable whether this kind of order may have served Germany (rather than the Bundesbank) well in the past.[12] The resulting institutional vacuum under EMU has certainly left Euroland in a precariously exposed position—it is still not settled today who is really in charge of exchange rate policy in Euroland. When I questioned Commissioner Almunia on this point, with reference to potential risks posed by global imbalances at a conference in Brussels in March 2006, he publicly confirmed this rather amazing status quo.[13]

Perhaps there would be nothing to worry about if Euroland's quite balanced external position really verified that it has "kept its own house in order," as Otmar Issing (2005) seems to imply when he bluntly asserts that Euroland "has not made any real contribution to the build-up of current imbalances." In Issing's view, Euroland also has no major role to play in the global current account adjustment process, but should simply continue on its well-trodden stability-oriented path. While Ahearne and von Hagen (2005) may not disagree too much with this judgment as such, they still consider European policymakers' apparent complacency

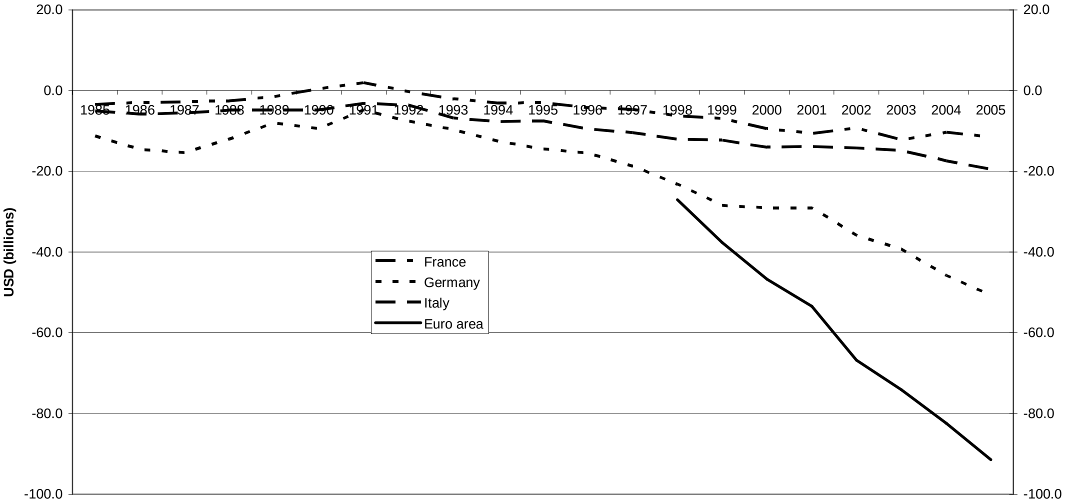
[12] Bibow (2005) argues that the Bundesbank model only worked for Germany because and as long as its main trading partners behaved differently, explaining why Germany got itself into trouble in the 1990s by imposing German "stability culture" upon Euroland members.

[13] Shortly after the issue aroused a public conflict as ECB president Trichet failed to respond to a letter by the Eurogroup's chairman Juncker and Commissioner Almunia proposing a closer dialogue between politicians and the central bank (see "Juncker hits at ECB president," Proissl 2006).

unwarranted, observing that: “Europe may not be part of the global current account problem, but it is bound to be part of the solution.”

Of course, Issing’s denial is futile. Similar in size to the United States, Euroland has proved oddly dependent on external growth under the Maastricht regime. The U.S.’s “new economy” boom proved decisive in getting the euro off the ground in the first place (allowing the members-to-be to meet the Maastricht criteria in the last minute). On average, net exports have made a small positive contribution to Euroland’s meager GDP growth since 1999, too. Euroland’s current account surplus has only evaporated recently, turning into a rather small deficit due to the oil price boom. Meanwhile, Euroland’s bilateral trade surplus with the United States has surged (see figure 9), which underlines that the euro’s appreciation since April 2002 has failed to rebalance relative competitiveness positions and that Euroland remains at the mercy of the U.S. growth engine.

Figure 9. U.S.-Euroland bilateral trade imbalance



Source. EcoWin/Reuters

The popular “victim view” that the euro has borne the “brunt of dollar depreciation” can, thus, also be put to rest. In fact, the euro has barely risen above its launching value of 1999, which many regarded as undervalued at the time. If anything, the victim view captures justified frustration about the fact that Euroland has been the only world region that managed to stagnate in the middle of the longest global boom since the 1970s. That, however, happened because Euroland *chose* not to participate in the deliberate reflation policy of the U.S. dollar bloc—which has nonetheless sponsored Euroland's ongoing recovery. Before subscribing to Ahearne and von Hagen's fears that Euroland might yet become even more of a victim should the external motor stutter, it may be time to admit that Euroland does not have any natural right to perpetually freeload on U.S.-sponsored growth.

Searching for Euroland's problem "elsewhere in the world economy" is much beside the point anyway. Euroland's primary problems are truly homemade. Commenting on the persistent growth differential between Euroland and the United States, Padoa-Schioppa's (2005) remarkably candid admission highlights that the "main challenge for Europe today is: to increase its potential and actual growth. … Not only is potential growth relatively low in Europe; its actual growth performance is also persistently falling short of that potential." If we trusted our textbooks, there could hardly be any clearer evidence of a macroeconomic policy failure.

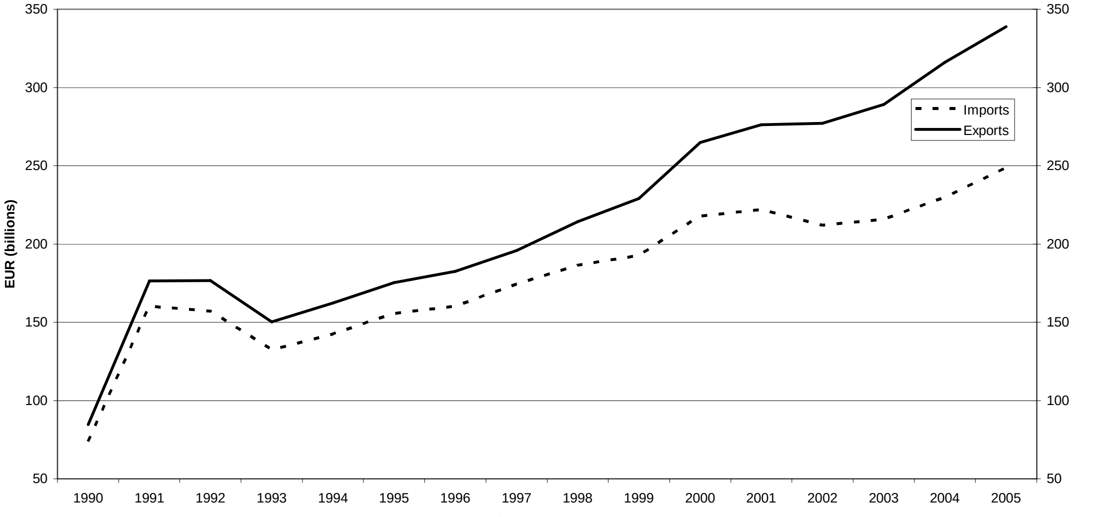
Indeed, the ill-designed Maastricht regime has failed dismally, seeing to it that Euroland drifted into protracted domestic demand stagnation even in the middle of a global boom. Contrary to Bundesbank wisdom, then, the mix of stability-oriented monetary policy, fiscal consolidation no-matter-what, and notorious wage "moderation" has not caused growth, but stagnation. Excessive wage disinflation has amplified home-made demand weakness and notorious reliance on export-led growth.

As IMF assessments explicitly confirmed until recently, slow growth in Euroland and Japan have contributed markedly to the build-up of imbalances. Today, their combined bilateral trade surplus vis-à-vis the United States is in the same order of magnitude as the Chinese one. Not only has Euroland paid a huge domestic cost for its self-imposed protracted stagnation. Externally, it has missed a great opportunity too—foregoing the intermediation profits that reserve currency issuance brings with it. No conflict has existed between pursuance of domestic equilibrium and benign neglect regarding the external position. Boosting domestic demand would have served both Euroland and the global economy well. In fact, failing to do so is inviting the risk of being offered an even bigger part later on, albeit abruptly.

Essentially, there is a clash of policy orientations ongoing in the global arena. Following Bundesbank wisdom, highly dogmatic policymakers have done too little to keep domestic demand growth up in Euroland. By focusing on full employment at stable prices, highly pragmatic U.S. policymakers ended up doing correspondingly more to boost U.S. domestic demand, thereby offsetting the external drain of their policy stimulus resulting from freeloading elsewhere, including Euroland. U.S. interest rates therefore had to drop, and asset prices to rise, *more than otherwise*, to induce the extra spending needed to drag along the domestic demand laggards. This order is not all that new. Traditionally, the United States has enjoyed long upswings occasionally interrupted by brief downturns. The stylized facts for Germany are the opposite: short upswings followed by long periods of stagnation—the very pattern that is today replicated in Euroland. Exporting the German model to Europe has not only undermined the model's working in Germany but also brought stagnation to Euroland. Spreading the German disease to Europe is also bad news globally.

Figure 10. Germany pushing Euroland apart

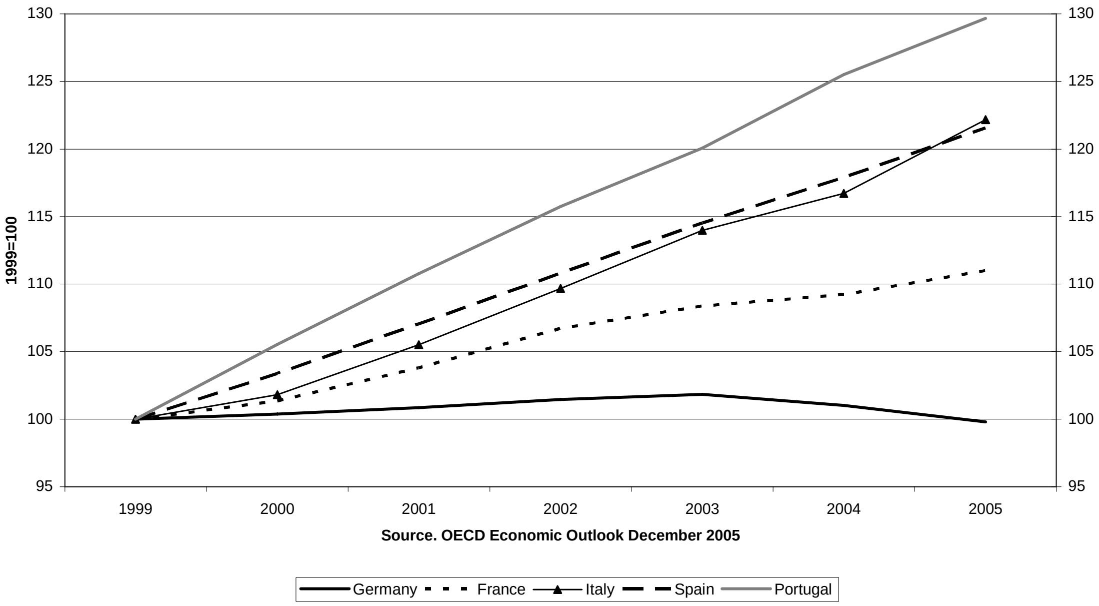
Germany's soaring trade imbalance with its Euroland partners



Source. Reuters

Alas, the situation has become even more complicated owing to the build-up of intra-Euroland imbalances that are hardly less spectacular than the ones much fretted about at the global level. As ever, Germany is at the heart of the problem: Germany’s trade surplus with its Euroland partners reached €90bn in 2005 and is soaring (see figure 10). The imbalance owes primarily to Germany’s beggar-thy-neighbor policies. Confronted with the fact that exporting Bundesbank wisdom—including wage moderation across Euroland—has caused stagnation rather than growth, Germany’s response was to shift German wage “moderation” into “higher” gear since 2001. In terms of unit-labor-cost trends, Germany has achieved a significant real “depreciation” in this way (see figure 11).

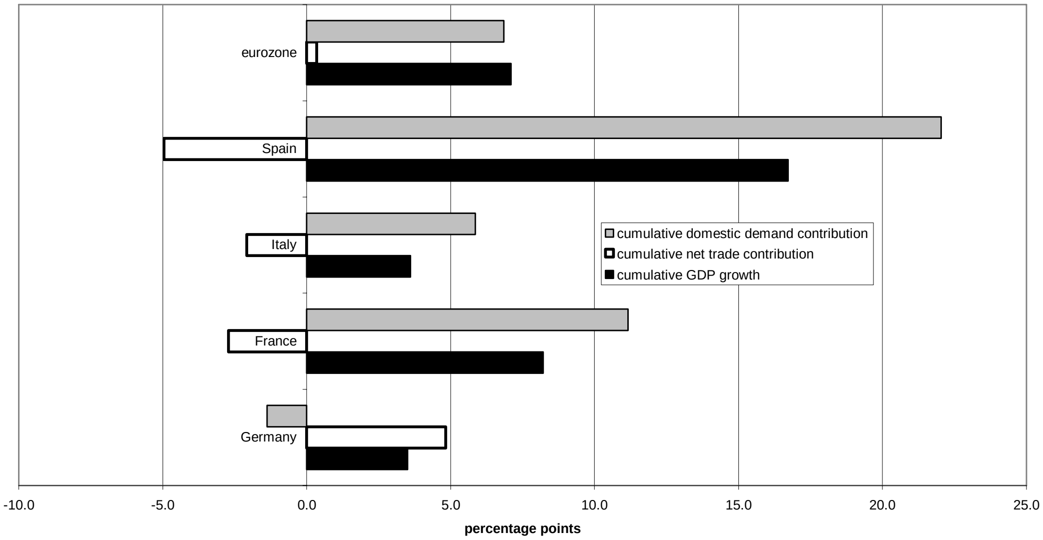
Figure 11. Diverging real exchange rates inside Euroland



Source. OECD Economic Outlook December 2005

The internal consequences of deflating incomes have been disastrous, too. Since 2001 the cumulative contribution of domestic demand to German GDP growth has actually been negative (figure 12)! In a way, at the regional (Euroland) level, Germany plays the very role that Euroland plays at the global level—domestic deflation paired with free-loading on external growth. The key difference is that inside Euroland, nominal exchange rates can no longer adjust—and tensions will, thus, have to be worked off in some other way (Bibow 2006b).

Figure 12. Cumulative GDP growth and its composition (2001-2005)



Source. OECD Economic Outlook no. 78 (Dec 2005)

The upshot is that Euroland is just as unlikely to play any constructive part in the unwinding of global imbalances as it is unlikely to get away unscathed with its remarkable macroeconomic mismanagement for much longer. Problems are threefold. First, apart from the damage at the domestic front caused by the ill-designed Maastricht regime, the policy vacuum left at Euroland's external front is not conducive to constructive engagement either; chances are low though that the Maastricht regime might get the fundamental overhaul that it truly deserves. Second, probably no less harmful than the flawed regime itself, Euroland's key policymakers refuse to grow up and live up to the fact that they are steering an economic giant that impacts on the rest of the world rather than being affected by it. Both Euroland's finance ministers and central bank politicians are notorious for their small-country mindset. What has worked for Ireland, Finland, or the Netherlands, will work for Euroland too, remains their (mis-)guiding principle. Third, mounting internal imbalances are further undermining unity. Inquiring whether regional cooperation might help to deal with global imbalances, Wyplosz (2006) observes on intra-Euroland imbalances that "incentives for common action are not particularly strong." *In fact, Germany's beggar-thy-neighbor strategy brought upon Euroland what EMU was supposed to ban forever—a competitive devaluation.*

7. CONCLUSION: RELUCTANT GLOBAL PLAYER AND NOTORIOUS GLOBAL DRAG

The analysis here has shown that today's global imbalances are the result of a complex set of causes and developments. Twin-deficit stories, all too popular in Europe, and claims about China's beggar-thy-neighbor policy, all too popular in the United States, are just scratching at the surface. BWII partly captures the U.S.-Asian "symbiotic" economic relationship, but only to an extent. More than an export-led development strategy by a new periphery is involved. Following financial liberalization and recurrent financial crises, there is a widespread desire among crisis-stricken newly industrialized and developing countries at large to prevent exchange overvaluation, to run current account surpluses, and to build-up massive foreign exchange reserves; rather than relying on fickle foreign saving and IMF policies. Essentially, this is a consequence of the absence of a sound multilateral global monetary and financial order; to a good extent global imbalances reflect systemic deficiencies.

Against this backdrop, the United States has accepted playing the "strong dollar" (exchange rate overvaluation) counterpart and acted as the global economy's growth engine, reaping some sizeable real benefits from filling the above monetary vacuum along the way. No doubt flooding the global economy with dollar liquidity at historically low interest rates has worked rather well, so well that despite global (ex-U.S.) demand weakness in product markets, oil (and commodity) prices have been pushed up to levels that are inflating current account surpluses of oil-exporting countries today. Of course, interest rates are low not because of any "saving glut" in capital markets (Bernanke 2005), but due to deficient demand in global product markets—which prompted easy monetary policies to stem deflationary pressures.[14]

U.S. macroeconomic policy pragmatism—filling the vacuum left by the deficient global monetary order—represents one side of the coin of today's global imbalances. Protracted failure to properly manage domestic demand elsewhere in the world is the other. This blame can hardly be put at China's door though. Through its dollar peg (since its own earlier crisis in 1994), China has served as a kind of back boiler to the Fed's aggressive easy money policy since 2001, thereby providing important growth stimuli to the region and the world economy. In any case, the U.S. personal saving rate is unlikely to drop another ten percentage points. Another drastic deterioration in U.S. public saving is unlikely to be tolerated either. Only an increase in domestic demand in the rest of the world would allow an orderly unwinding of global imbalances.

BWII completely fails to shed any light on the roles of certain other key players in all this. For one thing, Japan's current account surplus, while increasingly driven by net investment income, is still bigger than China's, which has only attained a globally significant scale since 2003 anyway. Yet, there is no pressure on Japan to let the yen appreciate. Perhaps memories of the yen's sharp appreciation in the second half of the 1980s, the prelude to Japan's "lost decade" that then ensued, inspire China's gradualism of today. For another, Euroland's role, aptly emphasized by the IMF until recently, has been written out of the play as the oil price boom turned Euroland's current account surplus into a small deficit.

Yet protracted domestic demand stagnation and notorious reliance on export-driven growth by the world's second largest economic area is too important a force to be ignored; even when it is convenient for "structural problem" story-telling. Padoa-Schioppa can again be singled out for candidly acknowledging that not all is well in the land of the euro:

[14] Summers (2004) referred to a "demand-supply imbalance abroad," judging that the "global economy today appears to be suffering more from the deflationary pressures associated with too little demand than the

> “In these early years neither the Eurosystem has acted as a full-fledged central bank nor euroland as a ‘country.’ The latter still lacks the constitutional structure to do so. The former is endowed with such structure but has not yet enlivened its charter with the necessary determination and political will. The result is that in the global arena an important player is missing from the field and another—a ‘central bank without a state’—stays on the field but does not play” (Padoa-Schioppa 2004).

The Maastricht regime’s enormous stagnation damages at the domestic front have been identified elsewhere (see Bibow 2006a, for instance). Its global ramifications may be less obvious, but they are no less consequential. No doubt Euroland has had its fair share in maneuvering the global economy into its current precarious corner. Moreover, Euroland is ill-prepared for playing any constructive part in the unwinding of imbalances; not to mention its lack of preparedness for coping with the consequences. The anti-growth bias at the Maastricht regime’s domestic front is paired with an institutional vacuum at the external front—it is not clear who is minding the store. Sadly, whoever may be in charge is likely to suffer from a small-country mindset bedeviling Euroland’s policymakers. On top of all this, incentives for common action and unity of interest have been undermined by Germany’s beggar-thy-neighbor wage deflation, which has caused soaring intra-Euroland imbalances. Euroland is drifting on a collision course, the euro’s long-term survival not assured.

inflationary pressures associated with too much demand.” The BIS (2006) identified a “shift in supply-demand conditions at the global level” among the factors responsible for subdued inflation pressures.

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