Global imbalances and the dollar: where next?  
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Contacts:  
Noel Brewer  
oel.brewer@citizensbank.com  
1-888-708-3600

Prepared by:  
Lucy O’Carroll  
Group Economics  
The Royal Bank of Scotland Group  
lucy.o’carroll@rbs.co.uk

Having fallen by more than 30% against the euro and 20% against the Japanese yen since 2002, the pace of dollar decline has picked up in recent weeks. The dollar has now fallen to its lowest levels against the major currencies since the early 1990s. Is this a prelude to more rapid and destabilizing dollar realignment, reflecting worries about global imbalances? Or is it part of a smooth adjustment that will eventually make the world economy a stronger and less risky place?

Global imbalances matter, and not just because of recent financial-market volatility. If the US deficits remain high, the economy will be less able to respond to future shocks. The US needs to get itself in better fiscal shape to meet the rising costs of an aging population. Low US national saving and the funding of domestic consumption by external finance also constrain future living standards. Outside the US, the longer the imbalances continue the more painful the eventual correction as the value of countries’ dollar-denominated assets falls, real interest rates rise and global trade weakens.

Up to now, there have been good reasons for these imbalances. We would expect the US economy to run a current account (CA) deficit - though not necessarily such a large one - because of the dollar’s reserve-currency status. The widening of the US deficits since 2000 also helped the recovery from global recession. In addition, the US CA deficit has provided an offset to the accumulation of CA surpluses elsewhere, particularly in Asian economies keen to maintain exchange-rate competitiveness.

The current situation is not, however, sustainable. With funding costs of over $2 billion each working day, the US is single-handedly swallowing up more than 70% of the combined CA surpluses of the rest of the world. Servicing costs will eventually become burdensome. Investors’ wish to increase the share of dollar-denominated assets in their portfolios is likely to diminish. The elimination of the ‘twin’ US deficits of the mid 1980s shows that large CA imbalances can be addressed without significant adverse consequences, but external conditions are less favorable than in the mid 1980s, when improving growth elsewhere helped to underpin the US economy’s adjustment.

The dollar’s decline is most likely to remain relatively smooth, though a more rapid and destabilizing realignment is still a possibility. Even if the adjustment is gradual and orderly, it could be sizable. The dollar could have 15-20% further to fall in trade-weighted terms, if history is any guide. To bring the US CA deficit back to a more sustainable level, however, dollar depreciation needs to be accompanied by fiscal consolidation, backed up with efforts to boost US private saving - though at the risk of a slowdown in the global economy.

Trade-exposed firms are at greatest risk from global imbalances and their impact on currency markets and interest rates. They can address these uncertainties by hedging, but revenues will remain at risk from weakening global demand. In the longer term, however, if exchange-rate developments prompt structural reforms in Europe and a more appropriate level for the Chinese renminbi, as well as correcting the worldwide CA surplus-deficit balance, global business conditions will be stronger and future risks potentially reduced.
1. How large are the imbalances?

At present, the US is faced with sizable deficits on both its budget (the excess of government spending over revenues) and its current account (the excess of what Americans spend on goods, services and funds transferred abroad over what the US earns from the rest of the world). How did these ‘twin’ deficits emerge?

In the eight years following the early 1990s’ recession, US real output and aggregate demand grew rapidly. The economy’s favorable cyclical position and prudent fiscal policies strengthened the fiscal outlook. High productivity growth and positive equity-market trends resulted in an investment boom and an expansion in the US current account (CA) deficit.

There is nothing new in the US CA deficit. Other than a brief period in the early 1990s, 2004 will be the 23rd consecutive year of CA deficits (Chart 2). In fact, the US dollar’s role as the main reserve currency is one reason to expect the US economy to run a CA deficit over time. What is, however, unusual (and what is worrying financial markets) is the sheer size of the CA deficit, which has risen rapidly from 2.5% of GDP ($236 billion) in 2000 to nearly 6% of GDP ($670 billion) this year - an all-time record, both in absolute and relative terms.

Chart 2:
The US budget and current account position (% of GDP)

In contrast to the CA deficit, the US budget moved from large deficit in the early 1990s into surplus by the end of the decade. From mid-2000, however, the US economy weakened sharply. Declining equity markets, the September 11th terrorist attacks, major corporate failures and the war in Iraq all weighed on confidence and activity. The federal government’s decision to underpin interest-rate cuts with fiscal expansion, together with military and security-related spending and the impact of slower growth on tax revenues, resulted in the largest fiscal deterioration over a short period since the Second World War, equivalent to around 6% of global gross savings. The US budget deficit’s share in GDP has fallen from a surplus of 2.5% of GDP ($236 billion) in 2000 to an estimated deficit of 4.5% of GDP ($520 billion) in 2004 - back to its mid-1980s’ levels in terms of its share in GDP.
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2. Why is the US running these deficits?

Chart 3: Global capital flows, 2003

Source: International Monetary Fund/Federal Reserve Bank of New York

It is not necessarily surprising or worrying that the US has run a CA deficit for so long. The US dollar’s function as the world’s main reserve currency (one that external investors value for its security and transmission qualities), the size of US capital markets and the attractions of the US as an investment destination explain why it can (and has) run a sizable CA deficit for an extended period. Furthermore, the sharp widening of the CA deficit during the past few years can be rationalized in at least three ways:

- **CA imbalances have allowed countries to smooth consumption over time.** Without the expanding US CA deficit (and its budget ‘twin’), the global economic recession of 2000-01 would have been deeper and more protracted. The Federal Reserve might well have had to cut interest rates below their 1% trough, and deflation risks would have increased.

- **Since CA deficits/surpluses represent the difference between domestic savings and investment, they have directed savings to their most productive uses.** If the US economy is able to attract capital inflows from overseas without difficulty, then the cost of capital in the United States is lower than it would otherwise be. As a result, living standards in the United States are higher. Furthermore, living standards in the rest of the world will also be higher, provided the returns on their investments in the United States are greater, at the margin, than the returns on spending at home. In this argument, all parties gain from the export of capital to the United States from the rest of the world.

- **Expansion in the US CA deficit has suited countries with large CA surpluses.** The counterpart to the most recent expansion of the US CA deficit has been growing CA surpluses elsewhere. The Eurozone countries are running CA surpluses close to trend as a proportion of GDP. The big change in recent years has been in Asia, where the CA position has switched from big deficits before the emerging markets crisis of 1997-98 to large surpluses after. Asian countries have been keen to translate their surpluses into dollar assets in order to maintain currency competitiveness, effectively purchasing dollars using their domestic currencies and thus lowering the value of their currencies against the dollar. Asian central banks financed around 70% of the US CA deficit in 2003 (see Chart 3). In Japan, furthermore, the resulting expansion of the monetary base has helped to address deflationary pressures.
3. Why do deficits matter to the economy?

The US fiscal deficit has been a necessary part of the recovery from recession, and its CA deficit has helped mop up global CA surpluses. But the CA deficit is no longer funding investment opportunities in the US economy, as it was until 2000, when investment as a share of GDP was growing. Since then, the investment share has fallen, and the deterioration in the CA has reflected heavy US government borrowing and an even faster fall in US national savings - which has continued beyond the end of the global economic recession. Furthermore, running persistent, sizable deficits can have a detrimental impact in the longer term. Chart 4 shows the key channels by which a fiscal expansion in the US affects its own economy, and the link to the CA deficit:

**Chart 4: Long-term deficits and the economy**

- **Fiscal multiplier**: A fiscal expansion implemented via tax cuts and/or higher government spending increases households’ disposable income and directly expands demand in the economy via rising government spending. As the extra income is spent, demand picks up by a multiple of the initial increase. Part of this pick-up in demand will be met by imports, spreading the positive demand impact to other countries.

- **National savings**: National savings are the difference between private savings and the budget deficit; so when the deficit rises, national savings fall. The 6% pick-up in the federal deficit since 2000 has been accompanied by a decline in the US net saving rate to below 2% of income - its lowest level since the 1930s.

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Interest rates: As the budget deficit soaks up available private saving, leaving a smaller pool of national saving to finance domestic investment, firms bid up the interest rate they are willing to pay for the smaller pool of available funds. Rising interest rates will discourage private investment, so reducing future national income.2

Current account: With a national savings rate of 2% of GDP, the US economy has two choices. It either reduces the amount invested in the domestic economy to 2% of GDP (so reducing the availability of productive capital in the future) or borrows the difference from overseas. However, as the returns to foreign savings do not belong to the US economy (even if the funds are invested in it), this also represents a constraint on future living standards.

Exchange rate: Initially, fiscal expansion may lead to dollar appreciation, since it stimulates inflows of foreign investment, in response to higher US interest rates. In the medium term, however, the situation is reversed. The exchange rate begins to depreciate to rebalance the CA deficit and generate surpluses to meet the additional costs of the higher net foreign liabilities accumulated during the fiscal expansion.

There is an additional, potentially more damaging, transmission channel. Worries that the size of the deficit could lead to fiscal deadlock, or leave little room to respond to future economic shocks, may undermine investor confidence. As a result, demand could shift away from dollar-based investments, resulting in rapid exchange-rate depreciation and sharp increases in interest rates on US government debt. Equity markets may also be adversely affected, reducing household wealth and raising the costs of business finance. Increasing interest rates and weakening economic activity may then worsen the fiscal position, causing a further loss in confidence, so magnifying the economic costs of running a sizable long-term deficit.

4 How long can imbalances last?

To say that the size of US deficits is unsurprising or explicable is not, therefore, to say that they are desirable in the long run. But for how long can the current situation be sustained?

There are a number of examples of high (and persistent) CA deficits among industrialized economies: Canada’s CA deficit averaged 2.5% of GDP between 1975-1998; the UK CA deficit averaged 4.1% of GDP between 1984-2003; and Australia’s CA deficit averaged 4.1% of GDP between 1974-2003. Global investors have had confidence that in these countries - and in the US at present - they have been able to achieve the highest returns for their funds against a background of political stability, legal systems that protect property rights and enforce commercial contracts, and financial systems that channel resources productively.

The US economy’s external borrowing is, however, much larger in absolute terms than has been the case in other industrialized countries that have run sustained, large external deficits for long periods. With a funding cost of over $2 billion each working day, the US is single-handedly swallowing up more than 70% of the combined CA surpluses of China, Japan and the rest of the world. The US CA deficit cannot continue to expand at its current pace, as servicing costs would eventually become burdensome. Even before that point is reached, investors’ wish to add to dollar claims in their portfolios is likely to diminish.

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2 The extent of ‘crowding out’ of private investment resulting from a long-term fiscal deficit will depend on a number of factors. For example, if the fiscal stimulus is initially accommodated by monetary policy (i.e. interest rates are not raised), crowding out will be smaller in the short term. Interest rates will eventually have to rise, however, as inflation starts picking up in response to the fiscal-monetary expansion.
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Table 1: Key signals of current account stress

<table>
<thead>
<tr>
<th>Stress signs</th>
<th>Comment</th>
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<tbody>
<tr>
<td>Rising domestic interest rates</td>
<td>No significant signs of stress to date: US short-term and longer-term interest rates remain relatively low and demand for new US debt securities is still reasonably strong.</td>
</tr>
<tr>
<td>Weak net external debt position</td>
<td>US net external debt is equivalent to around 25% of GDP - below that of several other industrial economies, including the Netherlands (30%), Finland (40%) and Australia (60%). However, even if the CA deficit were to stabilize at 5% of GDP, Goldman Sachs estimates that US net foreign liabilities could exceed 60% of GDP by 2020.</td>
</tr>
<tr>
<td>Weak international investment position</td>
<td>Though the US has been a net debtor since 1986, the net income on its international investment position has remained positive, as the rate of return on US investments abroad has so far exceeded that on foreign investments in the US.</td>
</tr>
<tr>
<td>Disorderly exchange-rate movements</td>
<td>The dollar’s decline has been orderly so far. It has fallen by over 30% against the euro since 2001 - but its broad, trade-weighted index has fallen by only 15% because of heavy Asian central bank intervention.</td>
</tr>
<tr>
<td>Investors in US assets approach portfolio limits</td>
<td>Japanese authorities withdrew from dollar reserve purchases in March, and China may be diversifying away from US Treasuries in new foreign-exchange purchases. But fears of an abrupt drying up of demand for dollars so far appear exaggerated.</td>
</tr>
<tr>
<td>Trade protectionism</td>
<td>A number of disputes in recent years, though there has not been a major escalation so far.</td>
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</tbody>
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So do financial markets appear comfortable with the size of the US CA deficit at present? Table 1 suggests that there have been relatively few significant signs of stress in the main sustainability indicators. Interest rates remain low and the US net external debt and international investment positions are relatively robust. However, recent anecdotal evidence that Asian central banks may be diversifying out of US Treasuries in their foreign-exchange portfolios has, alongside more general concerns about the size of the CA deficit and its economic effects, put the US dollar under pressure - despite positive data and improving US interest-rate returns.
5 How do imbalances unwind?

What does past experience tell us about how imbalances unwind? CA deficits in developed economies have risen as high as double-digit shares in GDP before markets have enforced a reversal (see Table 2). The median deficit peak has been around 5% of GDP - below the current level of the US CA deficit. Reversals have involved an improvement in the fiscal position, a real exchange-rate depreciation of 10-20%, slower domestic real income and investment growth, and an expansion of real export growth.

It is difficult to compare these cases with the US economy, however, since other deficit countries’ international borrowing has been largely in dollars, rather than in their domestic currencies. The US has been rare in its ability to finance its external deficit in a reserve currency, which has allowed it to increase the size of that deficit to unprecedented levels.

The US economy’s own history also shows, however, that CA imbalances, even large ones, can be defused without significant adverse consequences. The elimination of the ‘twin’ US budget and CA deficits in the mid 1980s is a case in point. Arguably, product and financial markets are now more flexible, and therefore better able to absorb shocks, than they were 20 years ago - so facilitating the adjustment of the present CA deficit. On the other hand, external conditions are less favorable than in the mid 1980s, when improving growth prospects in Japan and the European economies helped to underpin the adjustment process. In addition, the sheer size of the US deficit, the role of Asian central banks and recent dollar trends suggest that there is no room for complacency.

If, as we think, the imbalances are unsustainable, the issue arises of how the adjustment will play out:

- What chance is there that the imbalances will be corrected by a smooth readjustment of global growth rates - in other words, a pick-up in GDP growth rates overseas, boosting US exports?
- How far might the dollar need to fall?
- Would an improvement in the US fiscal position help to correct the CA deficit?
- What role could private savings play, and what are the risks?

Changing global growth and trade trends are unlikely to solve the problem alone

A pick-up in GDP growth rates overseas relative to the US economy could boost US exports, helping to correct the CA imbalance. After the dollar correction of the mid-1980s, for example, US economic activity continued to expand as domestic demand growth eased but was replaced by a strong contribution from net exports. More recently, however, Europe and Japan have relied mainly on export growth to drive their rebound from the 2000-01 recession and, as export growth has faltered, the latest data show that the same has happened to their recoveries.

Even if its competitors could outpace the US economy in terms of GDP growth, US merchandise imports account for 15% of GDP, whereas exports constitute only 10%. Exports would therefore have to grow much faster than imports to halt the deterioration in the trade balance. In addition, income elasticities for US imports of goods and services are estimated to be much larger than the foreign income elasticities for US exports of goods and services. This suggests that even if the US and other economies experience the same income expansion, the increase in US demand for imports will be greater than the pick-up in demand for US exports, and the US trade deficit will continue to deteriorate.
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Table 2: How CA deficits adjust in industrialized countries

| CA-GDP ratio | Typical CA ratio worsens for 4-5 years before it hits peak and then begins to adjust, taking another 3-4 years to return to near zero. |
| Exchange rate | Typically, real depreciation begins one year before CA deficit reaches peak, and continues for three years after, with an overall real depreciation of around 20%. |
| Currency crises | Of 21 episodes of currency crises in countries with large CA deficits, 17 crises occurred within two years of the CA reversal, whereas 4 took place before the CA reversed. This suggests that crises are more likely to occur in countries recovering from large CA deficits, but that they do not help predict CA reversals. |
| Trade balance | Nearly all of the episodes involve an increase in the export-GDP ratio over the first three years of their recovery, whereas only around half of the countries have declining import-GDP ratios. |
| Domestic income growth | Typically, annual real income growth of over 3% in the years before the CA deficit peaks. Income growth then slows to around 1% in the first year that the CA improves - indicating that, as domestic demand slows, the CA deficit narrows. |
| Interest rates | In most countries, short-term interest rates rise as the CA deficit hits its peak (typically around 2 percentage points), reflecting the position in the economic cycle and attempts to support depreciating exchange rates. Short-term interest rates then fall by around 3 percentage points in the first three years of CA reversal. |
| Twin deficits | In the typical case, there is little change in the budget deficit in the three years leading up to CA recovery, suggesting that while budget deficits may contribute to CA deficits, they are not responsible for deterioration. As growth slows during the recovery of the CA, most countries experience a rising budget deficit-GDP ratio. |
| Savings and investment | CA decline typically associated more with a decline in national savings than an increase in investment. In contrast, the improvement in the CA deficit comes primarily through reduced investment: nearly all the countries have reduced investment in the first two years that the CA improves, whereas only about half have increased savings. |
| Net international investment position | Of 14 countries for which data are available, ten had a negative NIIP-GDP ratio when the CA deficit peaked. In only two episodes was CA reversal associated with a reversal in the NIIP - but in most of the episodes the reversal was associated with some levelling off of the NIIP, a couple of years after the CA peak. |

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Imbalance adjustment requires further exchange-rate adjustment

Without an exogenous improvement in activity and trade trends, currency adjustment will be crucial in correcting the CA imbalances. Historical experience has shown that the fall in the deficit country’s currency may need to be sizable - up to 20% in real terms from a year before the CA deficit reaches its peak.

The scenario outlined in Table 3 suggests, however, that the required adjustment in the dollar may be larger. In this scenario, Asian central banks’ demand for dollar-denominated assets declines and their actual or effective pegs are loosened, resulting in a sustained 25% Asian currency appreciation. In the short run, an improvement in net trade provides a boost to US GDP. As domestic inflation and interest rates rise, however, US GDP growth slows sharply compared with our benign central US economy forecast. US domestic demand and its CA deficit are both permanently lower, but the CA deficit is improved by only around $100 billion per year, close to 1% of GDP, after four years.

Table 3: Impact on the US economy of CA deficit correction

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth</th>
<th>Domestic demand growth</th>
<th>CA deficit ($ billion)</th>
<th>CPI inflation</th>
<th>Fed funds rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>+0.2</td>
<td>-0.1</td>
<td>+22</td>
<td>+0.5</td>
<td>+0.3</td>
</tr>
<tr>
<td>Year 2</td>
<td>+0.3</td>
<td>-0.2</td>
<td>+68</td>
<td>+0.6</td>
<td>+0.8</td>
</tr>
<tr>
<td>Year 3</td>
<td>-0.3</td>
<td>-0.4</td>
<td>+79</td>
<td>+0.3</td>
<td>+1.3</td>
</tr>
<tr>
<td>Year 4</td>
<td>-0.6</td>
<td>-0.6</td>
<td>+100</td>
<td>+0.1</td>
<td>+1.3</td>
</tr>
</tbody>
</table>

Source: Oxford Economic Forecasting

Other estimates have put the US dollar’s required depreciation as high as 40%.\(^4\) In part, this is because the dollar’s unique position as the world’s main reserve currency has allowed the US CA deficit to reach an unprecedented size, so the inevitable correction may need to be larger. In addition, US exporters, and importers into the US, may limit the extent of CA improvement in response to dollar depreciation by holding their prices constant and taking the adjustment in profit margins. Furthermore, since dollar depreciation will clearly be mirrored by currency appreciation elsewhere, there will be a negative impact on the economies of US trading partners. Unless this is offset by domestic monetary or fiscal policy, it will subdue the demand for US exports and dampen the impact on the CA deficit.

Significant fiscal improvement seems unlikely - and may have little effect on the CA deficit

Could an improvement in the US budget position also help to correct the CA imbalances? Alan Greenspan has certainly argued that it might. The sizable US fiscal deficit that emerged in the 1980s, and persisted into the 1990s, eventually disappeared. This followed a series of efforts to impose fiscal rules intended to reduce, and eventually eliminate, the budget deficit, and the positive impact on revenues of the equity-market and investment boom.

A similar improvement in the current budget deficit appears unlikely. Official projections show a cumulative fiscal deficit of $5 trillion in the next decade, with the deficit falling to 0.1% of GDP by 2014. However, these estimates exclude likely increases in overseas military and homeland-security spending and an extension of the 2001-03 tax cuts. So there is little reason to expect a sizable reduction in the budget deficit in the next ten years. Beyond 2014, furthermore, Social Security, Medicare and Medicaid costs are expected to rise sharply, partly for demographic reasons, adding to the fiscal pressures.

Even if the budget outlook were to improve, perhaps as a result of discretionary spending caps or tax increases, it might lead to only a relatively small additional improvement in the CA deficit, depending on the response of monetary policy. If interest rates were held down to stabilize output and inflation, the savings ratio could be lower and private consumption and investment remain higher than would otherwise be the case. In addition, households may take the view that the fiscal consolidation reduces the government’s likely future need for tax revenues to pay for its borrowing - again implying that private savings may fall (and consumption increase). The feed-through to import demand of the increase in private consumption and investment would partially offset the downward impact on the CA deficit of the pick-up in public saving. Indeed, Table 2 suggests that, in the past, there has been little or no positive relationship between CA and budget deficits.

Prompting higher private saving increases recession risks

With little likelihood of sizable fiscal adjustment and no real sign of independent action by Asian central banks, the US administration could attempt to improve the CA deficit by encouraging private saving (reducing consumption), so shrinking import demand. After all, an increase in US private-sector savings was the main counterpart to CA improvement in the 1980s, though Table 2 suggests that this is relatively unusual. However, the unfavorable balance of import-export elasticities and GDP shares (discussed above) suggests that the increase in private saving would need to be sizable to have an impact on the CA deficit. Furthermore, with interest rates still low and only modest increases in prospect, it could take several years of savings expansion (consumption slowdown) to have a significant impact on imports and the CA deficit. If a faster adjustment were made via more rapid rate tightening, the combination of any fiscal improvement and a significant reining back of consumption would increase the risks of a severe US downturn, which would then be transmitted globally via trade, currency and equity markets.

6 What are the implications for business?

In this environment, trade-exposed companies will be at risk of slowing demand across all markets, at least in the short-to-medium term, as imbalances unwind:

- In the United States, the inflationary impact of further substantial dollar decline, which is unlikely to be offset in the short-term by substantial fiscal tightening, combined with a desire to raise the rate of private-sector saving, could push interest rates higher - certainly above the levels that bond markets are currently pricing in. The dampening effect of tighter monetary policy and a (somewhat) reduced fiscal stimulus would also be reflected in equity markets.

- In the United Kingdom, the implications depend crucially on what happens to sterling. So far, sterling’s rise against the dollar has been more than offset by decline against the euro. In trade-weighted terms, sterling’s 5% fall has provided a monetary stimulus that has offset much of the interest-rate tightening that has taken place since November 2003. If this trend were to continue, the deterioration in overall UK competitiveness from
Further dollar depreciation would be limited. Given the uncertainties, however, the risks are sizable. Furthermore, the negative impact on UK export markets could be significant in the medium-term, even if sterling were to move in a favorable direction against the euro, if domestic demand in the Eurozone were to be severely affected by its appreciating currency. US import demand is also likely to be subdued. In addition, weaker global equity markets would dampen activity via wealth and investment effects. Overall, the Bank of England could face a balancing act: trying not to over-stimulate the economy in the short-term, when exchange-rate movements provide a monetary stimulus, while being prepared to underpin activity in the medium-term if the dollar depreciation and impact on global demand is sustained.

In the Eurozone, the region’s currency has already risen by 30% against the dollar since 2002. It is anyone’s guess as to how much further it could rise but, if the trends of the mid 1980s are anything to go by (when the dollar’s fall in trade-weighted terms was 30%, compared to a 15% decline so far since 2002), there could be a substantial further pick-up. Though most of the Eurozone’s trade is intra-regional, weak domestic demand has meant that external market conditions have been crucial in driving the very modest recovery from the global recession of 2000-01. Further exchange rate appreciation against the dollar (and the Asian currencies that are actually or effectively pegged to it) would therefore have serious economic consequences for the region, and could substantially delay the European Central Bank’s moves to begin the rate-tightening cycle. If, however, Asian currency pegs were to be loosened, this could relieve some pressure on the euro and the negative impact on the region could therefore be reduced. Eurozone interest rates could potentially be cut, though they are already fairly close to the floor.

The negative impact on countries such as Japan, with very little room for monetary and fiscal maneuvering, could be sizable. Emerging-market economies could also find themselves caught in a flight to quality, if market interest rates pick up in response to the perceived increase in risk.

The timing of any further dollar correction is unpredictable and, even if it is orderly, could be sizable. Companies will therefore potentially be exposed to significant currency risks. UK firms with sizable dollar-denominated income flows and large euro-denominated cost streams are likely to be most adversely affected. In contrast, firms exporting to the Eurozone with dollar-priced inputs could experience a boost to revenues - though this might well be offset by weaker demand in export markets.

Interest-rate movements could also potentially be larger and more volatile than the benign conditions reflected in bond markets at present. In economies such as the UK, with a strong government debt position and room for maneuvering on monetary policy, interest rates could be cut to stimulate domestic demand. But higher US interest rates and increasing uncertainty could lead to the global transmission of rising real interest rates across financial markets, particularly to higher-risk economies.

On the other hand, companies have already stood up well to more than two years of currency-market adjustment and uncertainty over the path of interest rates as the global economy has rebounded from recession. Monetary and fiscal authorities have also generally responded appropriately. Provided further adjustment remains orderly, currency and interest-rate hedging should help business planning against a reasonable policy backdrop.

7 Conclusion

There are no easy answers to global imbalances. A rebound in non-US GDP growth of the kind experienced in the mid 1980s is unlikely to return the global CA deficit-surplus position to more sustainable levels. Dollar depreciation
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alone will not work, particularly as any move in Asian pegs seems unlikely (at least at present) to be sufficiently large, and as Asian countries retain their preference for saving over spending. Fiscal consolidation may be helpful, but has to be backed up with efforts to boost private saving in the US - though at the risk of transmitting economic slowdown worldwide.

Given the global reach of these imbalances, a successful resolution would ideally involve a cooperative strategy that includes medium-term fiscal consolidation in a number of industrial and emerging market countries; greater currency flexibility, particularly in emerging Asian economies; a faster pace of structural reform in the Eurozone; and further corporate and banking reforms in Japan. Institutions such as the G8 do not have a sufficiently wide geographical remit to force the pace on cooperation. Without an obvious means of facilitating such an adjustment at present, global institutions appear to have fallen behind the pace of globalization.

A relatively smooth further dollar adjustment is the most likely outcome, but the risk of rapid and destabilizing realignment remains. Even if the dollar’s adjustment is orderly, it could be sizable - up to 20% in real trade-weighted terms, if history is anything to go by. The path of US interest rates is also subject to greater uncertainty than is currently being priced into forward markets.

The situation is not, however, irrevocable. Hedging can be used to mitigate both currency and interest-rate risk. In the longer-term, furthermore, if exchange-rate developments prompt structural reforms in Europe and a more appropriate level for the Chinese renminbi, as well as correcting the worldwide CA surplus-deficit balance, global business conditions will be stronger and future risks potentially smaller. Finally, history has shown that large global imbalances have unwound in the past without significant disruption. The world has withstood a number of sizable shocks in recent years, from the Asian crisis to high oil prices. If the global economy’s increased flexibility and its deeper capital markets have withstood such tests already, arguably, it stands a fair chance of meeting this latest, and possibly largest, challenge.