Italian Association for the Study of Comparative Economic Systems
16th National Scientific Conference, Parma, 21-23 June 2007

International payments imbalances and the prospective role of the euro

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Introduction

The term 'global imbalances' has recently come to describe the latest formation of increasingly large disparities in the balance of the international current accounts of main world regions, notably the US and Asia. Considered a warning signal of international financial instability, it is also being seen as a symptom of current world asymmetries in policy regimes and growth rates. Addressing the problem should thus aim at setting world growth on more solid ground, and begin to tackle the true global imbalances of today's world.[1] In this global scenario, the single currency area in Europe (or: Euroland) is a new player. How does the euro economy navigate in the midst of international payments imbalances? And what can Euroland do to contribute to correct global payments imbalances in such a way as to play a role within the broader scope to rebalance the course of world economic development?

Judging from the current triad of EU policies (namely, federally-implemented price stability, federally-constrained fiscal balance of national budgets, and a prescription that countries accomplish structural reforms on an individual basis), Euroland's potential contributing role to a benign rebalancing of global imbalances

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seems hampered by the fact that Euroland has limited means to solve its own internal imbalances. In fact, the effort to shape, in a slow growth environment, a more competitive and dynamic economy through individual countries' initiatives guided by the 'open method of coordination', and not by way of common governance, may keep Euroland busy for a long time, a time during which the external environment may rapidly change and become less favorable. Common governance established by common monetary policy and a common exchange rate is yet insufficient to make significant steps towards reducing traditional divergences in the areas of social and labor policies, dynamics of unit labor costs, budget and taxation decisions, thus augmenting the strains of euro members rather than multiplying their potential, as documented elsewhere in this volume. This also indicates little alertness on the part of Euroland's architects regarding the distinct possibility that current world developments may turn against Euroland and force it to facing considerable challenges. Indeed, as argued in this chapter, virtually all scenarios of international payments 'rebalancing' currently considered entail problematical consequences for Euroland, and a more resolute willingness to actively play a global role seems not only to be wished for, but a condition for the success of the EMU project. Adopting a proper system of macroeconomic governance in a truly integrated single market, as warranted by its new currency, is one of those structural reforms that should be given priority in the interest of Europe.

The widening of international financial imbalances

The recent wave of concern for 'global imbalances' in international payments dates from the late 1990s when a persistently growing US current account deficit becomes concurrent with a persistently growing negative net international

investment position of the US. Until then, the question of the sustainability of current account deficits and international debt had been studied exclusively with reference to developing and emerging countries. With the escalating excess of foreign-owned assets in the US over US-owned assets abroad, however, there developed concerns that financial flows to the US could reverse, thus engendering a financial and dollar crisis.[2]

A full parallel with the financial dependence of developing and emerging countries, however, is unwarranted: the external account deficit on goods, services and income payments of the country issuing the world key currency is not subject to the same financial constraints as that of any other country. In providing the world with international liquidity, the US issues dollar-denominated claims that the rest of the world demands as a means of payment for acquiring financial assets in the US, as well as for trading with third parties (as most of the international invoicing is denominated in dollars). The accounting imbalances thus reflect, in fact, a market equilibrium condition between demand and supply of dollars. As compared to the situation of a developing country where debts are denominated in a currency that the country cannot issue, the fact that virtually all external outstanding liabilities of US economic units are denominated in dollars softens the US borrowing constraint. This gives the US the privilege of a longer time horizon available before the external financing constraint begins to bite. Indeed, and to many's surprise, the US imbalance position survived with no dramatic repercussions in the afermath of the dot-com bubble and the ensuing recession: an array of US macroeconomic policies targeted at domestic growth set both the tone of the dollar in floating currency markets and the tone of policy steering in countries that were willing to follow (i.e., peg) the dollar.

The result was that the US went back on a growth track and its current account continued to enlarge.

With the turn of the century, the US financial imbalance has continued to increase while Latin America, emerging Asia and oil-exporting economies have reversed their external deficit positions into increasing current account surpluses. Figure 13.1 documents the changing set of international financial positions by relating the current account balances of selected world regions to domestic (private and public) financial balances, through the 1995-2005 decade. From national and flow-of-funds accounting we know that the following identity holds for each accounting system:

> Private sector net borrowing + Public sector net borrowing = Current account deficit.[3]

The diagonal line in Figure 13.1 shows combinations of private and public accounts that deliver a balanced current account position. The actual current account balance of each country (or region) is identified—at three dates of observation (1995, 2000, and 2005)—by plotting private net borrowing against public net borrowing: the resulting distance from the 'Current Account (CA)=0' line measures a deficit (if a combination lies to the right of the line) or a surplus (if to the left).

In the decade considered, it is worth noting how the widening of the US external deficit has persisted, irrespectively of the changing combinations of private and public borrowing patterns: the external deficit was concurrent, in 1995, with a government deficit; in 2000, with a government surplus that was more than offset by private net borrowing; and in 2005, with both private and public net borrowing. The growing external deficit reflects an ongoing theme of the US economy that has endured unaffected by changing cyclical conditions and policies: an increasing excess

of domestic demand over domestic product, with corresponding demand spillover effects on the rest of the world.

The Asian pattern is quite different, as the current account position of emerging Asian countries reversed in the period considered. In 1995, net public borrowing was concurrent with an external deficit that then turned into a rising external surplus in 2000 and 2005, when rising private savings (and profits) more than offset fiscal deficits. Not only the US and Asia are now on opposite courts with respect to the 'CA=0' line, but they have now reached antithetical positions. When we consider, in addition, the reversal (from surplus to deficit) of external account positions of Latin America and oil-exporting countries, the deficit court remains near empty, with the notable exceptions of the UK, Australia, emerging Eastern Europe, and only a few countries now incorporated into the euro currency area, while Euroland as a whole has, in its brief history, gravitated near the 'CA=0' line in spite of relatively large swings in fiscal balances, mostly offset by corresponding swings in private sector's financial balances.

Such polarization between the US, on the deficit side, and the rest of the world, on the surplus side, is particularly meaningful if one considers that countries that consistently belong to opposite sides of the 'CA=0' line pursue very different growth strategies. A country on the right side of the line is a country that generates net savings (including profits) abroad by means of expanding demand *by* domestic units (and *for* both domestic and foreign units, depending on its marginal propensity to expend and import) financed by private and/or public deficits. By contrast, a country on the left side is a country that absorbs net savings (including profits) from abroad by means of an expanding demand *for* domestic units (and *by* foreign and domestic units, depending on its marginal propensity to expend and import)

financed abroad. Considering that any external deficit requires the disposal of a means of payment accepted internationally and that any external surplus entails accumulating such means of payment, then, for the time a region lays to the right of the 'CA=0' line, it is a net generator of world demand and a demander of international finance, and for the time it lays to the left of the line, it is a net dragger of world demand and a supplier of international finance.

Asia moved over to the left of the 'CA=0' line following the 1998 crisis.[4] This conspicuous reversal of a growing number of developing and emerging countries in Asia, and elsewhere, is likely to reflect an increasing reluctance of being in the risky court of net world demand generators. The 1998 crisis showed that, apart from the privileged position of the key currency country, such condition is tolerated for limited time periods before capital flows reverse. Successful growth-oriented policies in the US that prevented the world recession that many had foreseen in the aftermath of the stock market crisis corroborated this choice.

While these developments have led to the widening of current account disparities, financial and currency markets continue to play a crucial role in maintaining this 'equilibrium of imbalances'. The dollar provides the key world currency, while other currencies of higher and lower hierarchy have acquired liquidity at various degrees relying on their capital markets. The sizeable widening of the US current account deficit in a context of sustained world growth (and increasing polarization of current account imbalances as described above) has been made possible by the world's appetite for dollar-denominated assets. From a purely accounting view, the re-cycling of dollar liquidity back to the US is a precondition to prevent that spending income abroad drains liquidity in the US. In this sense, foreign investment in US assets has provided a method equivalent to the one Keynes

considered essential to any international monetary 'system', as well as an element of his own proposal for reform, i.e., 'a method by which the surplus credit balances arising from international trade, which the recipient does not wish to employ for the time being, can be set to work … without detriment to the liquidity of these balances and to their holder's faculty to employ them himself when he desires to do so' (Keynes 1980, 169).

At the same time, the significant widening of imbalances was made possible by the fact that another element Keynes considered essential is missing in today's 'system', i.e., 'an internal stabilizing mechanism, by which pressure is exercised on any country whose balance of payments with the rest of the world is departing from equilibrium in either direction, so as to prevent movements which must create for its neighbors an equal but opposite want of balance' (ibid.). This was a missing element in the Bretton Woods system as well, and one that contributed to its demise. Indeed, when drawing parallels between historical international payments systems,[5] one should be reminded that this remains today an element of weakness.

In sum, financial imbalances will continue as long as both surplus nations and the largest deficit nation do not feel the need to adjust, and this is being seen today as leading to either of two scenarios. Under a Classical view, the widening and polarization of imbalances just cannot go on forever as it increases the vulnerability of the international economy: if less-than-efficient market mechanisms have not prevented the built-up of an excessively unbalanced situation, then an abrupt crisis can only be avoided by returning quickly to 'sound policies'.[6] Under an alternative view, imbalances may continue unchecked as long as they remain coherent with a world system that combines different, complementary strategies: the current system of dollar-dominated international financial markets permits export-led countries to

recycle their surpluses back to deficit countries (i.e., the US) and hence prevents a US slowdown, with the US and Asia keeping the world in balance by pulling in opposite directions. Even under this less dramatic scenario, however, there remain several elements of concern, including a higher capital mobility (than under the Bretton Woods system) and the dependence of the local stability of this system on mutual interest, including an enduring compatibility with domestic US objectives. A situation where world stability requirements under this latter scenario should conflict with the domestic goals of the key world currency, such as a surge in US inflation, would be a real threat to the dollar-based recycling of financial imbalances, and thus to world growth.

Risks of a US-Asian adjustment

Most economists agree that current 'global imbalances' pose a real threat to the world economy, but the same diagnosis and therapy are not shared by all. Inevitably, the character of solutions strictly depends on the goals one sets, and in the debate of diverse, alternative and competing policies one must first clarify the goal they aim at. In this respect, the IMF (2005, 2006) has expressed serious concerns that the widening of financial imbalances may prove to be only temporarily sustainable and that the current pattern will have to be unwounded by dollar depreciation as foreigners will be increasingly reluctant to hold dollar-denominated assets. In the face of an increasing vulnerability, the IMF has warned that financial imbalances require policy correction and, if left unchecked, will correct through an abrupt and risky dollar drop. In describing the aims of a policy coordination effort, the IMF is thus stressing the goal of reducing the danger of a financial meltdown ignited by a dollar collapse.

This may well be a concern for the world economy, and the analysis will return to this issue below. Yet, there exists an equally, if not more important, concern that should guide policy action: US internal economic conditions and policy choices remain crucial to world economic growth as long as the majority of countries are highly dependent on US demand. In fact, the risk is that a weakening of the American economy may ignite a global recession.

This difference in diagnosis and goals matters because while dollar stability may require that adjustment falls predominantly on the US, and possibly on Asian pegging policies, a reduction of the world economic dependence on US consumers and business may lead us to consider adjustment on other players, notably, and perhaps somewhat counter-intuitively, Euroland. Indeed, one should not disregard that some of the policies endorsed by the IMF do in fact consider the latter concern, prodding a boosting of growth in Japan and Europe, thus indicating the need to widen the effort to generate demand engines beyond the US. Yet, the IMF's biggest emphasis remains on the dollar stability concern, aiming at re-equilibrating actions (such as a reduction of US private and public net borrowing) that could easily prove counterproductive to demand and growth, thus further increasing the risk of the world economy running out of steam.

By combining some key contributions on the question of imbalances, the IMF promotes adoption of a coordinated package of policies: fiscal measures in the US to spur private saving and cut the federal deficit, exchange rate flexibility, and reforms that spur domestic demand in surplus countries. Thus, the IMF prescribes a constellation of policies, in consideration of the fact that imbalances are common to a number of regions and that rebalancing international payments must necessarily entail both a reduction of deficit positions and a reduction of surplus positions.

Entrusting both substitution and income effects, policies are expected to foster an orderly market adjustment by providing exchange rate flexibility in Asia and fiscal consolidation in the US before market movements become disruptive, and spur growth predominantly through policies that enhance productivity in Europe and Japan and lead to increased spending by oil exporters.

When it comes to priorities, however, pundits hold different views. An influential view places an exceptional emphasis upon the US imbalance position and the need that US policy makers change their course of action and begin to restore 'sound policies'. One can find a number of apparently intuitive and yet questionable reasons why most of the adjustment of existing imbalances should fall on the US: First, while the surplus side of global imbalances is shared by, and spread among, a number of world regions, the deficit side concentrates on US external accounts: over two thirds of all external deficits originate from the US. This has unwarrantedly suggested that because the anomaly sits primarily in one country, adjustment should be made at the US domestic level. The fact that the US is the world region furthest away from 'equilibrium', however, does not warrant that it is the region that must adjust first. Should the US attempt to reduce imbalances by cutting down the flow of savings they generate abroad to increase domestic savings, while others continue to attempt to "import" savings from abroad, an 'international paradox of thrift' situation would develop: a demand drop that would reduce income and investment and actually result in less, not more world savings. Slowing down the biggest demand engine could only make sense if first demand would be rising elsewhere. The point is that this cannot happen as long as Asian and key European countries remain strongly oriented to use exports as their demand engine.

Another reason for commonly emphasizing the need for US adjustment lays in the conventional argument that a deficit country faces a financing (though in the case of the US 'soft') constraint, while surplus countries do not: the US may have more leeway than emerging countries, but ultimately it must adjust. This asymmetry is often described as being one between (borrowing) countries indulging in spending profligacy and (lending) countries practicing frugality. Finally, the 2000-03 dramatic reversal of US fiscal accounts has provided an additional source of concern for US fiscal sustainability in the face of an increasing outstanding net foreign holding of Treasury securities. A group of American economists have vigorously blamed both the excessively low personal saving rate and the looming budget deficit in the US for reducing national saving and creating the needs of a rising borrowing from abroad to 'finance domestic investment'. In their view, rising debt bears on Americans both for the returns that must be paid on debt and for the increased risk that this may entail, eventually driving US interest rates up,[7] pushing the dollar as well as investor confidence and the stock market down, and thus spreading to the real economy: 'These same forces could lead investors and businesses to scale back use of the dollar as the leading world currency for international transactions. That, in turn, could limit the ability of the US to finance its current account deficits through dollar-denominated liabilities and thus increase the nation's net exposure to substantial exchange rate changes' (Rubin, Orszag and Sinai 2004, p.32).

This connection between US fiscal soundness and the global role of the dollar is questionable in at least two respects. Regarding the fears that a dollar drop implies an enduring dollar crisis, due considerations should be given to the following: the dollar has proved it can stand large fluctuations in its international value with no impact on the stability and liquidity of US financial markets. Investors' activity in

temporarily reallocating international portfolios does not create conditions whereby the dollar loses its appeal as key world currency. Arguably, should 'unwarranted fears' develop, initiating a dollar crisis, the most powerful central bank in the world would be operative, and other central banks would be highly interested to cooperate to protect their domestic investors and their own portfolios, until an orderly dollar market is restored.

On the other hand, should fiscal retrenchment, or tax hikes, in the US, unaccompanied by a rising US private net borrowing, move the US towards current account balance (i.e., towards the 'CA=0' line in Figure 13.1), this would be concomitant with a reduction of the surplus imbalance elsewhere. Restoring 'sound policies' in the US would thus prove counterproductive, it would reduce the US net generation of world demand and be deflationary for the US and the world. It could well contribute to moving regions in Figure 13.1 towards the 'CA=0' line, but at the cost of a generalized reduction of US and world growth. Considering the relative importance of the US economic engine, the effect could be devastating if demand did not increase first elsewhere in the world.[8]

When the deflationary effects of unilateral US adjustment are considered, one should begin looking elsewhere. A conventional alternative recipe is exchange rate adjustment, and this would involve a policy effort by the Asian countries, notably China. Considered as a way to address concerns about the deflationary effects of a unilateral US adjustment, the aim is to simultaneously restore 'sound policies' in the US (by increasing US savings) and in Asia (by eliminating exchange controls), and ultimately to guide a price adjustment. In this vision, a concerted effort of the US and Asia to adjust imbalances bilaterally through a reduction of the US fiscal deficit parallel to Asian currencies' appreciation[9] would lead to an orderly global

rebalancing through 'expenditure reduction' and 'expenditure switching' (cf. Setser and Roubini 2005).

It is worthwhile to recall here Keynes's approach on how to stabilize international imbalances, which was based on a concerted effort to keep world aggregate demand high. Keynes did not trust the price mechanism as a means to restore financial balances and full employment: he stressed income and balance-sheet effects of exchange variations on top of uncertain price-elasticity and expenditure switching effects. Today, in a world of international financial flows and international outsourcing, a dollar drop is even less likely to reduce imbalances. For aiming at sufficiently large expenditure switching effects the dollar drop should be happening against nearly all surplus regions currencies, including the now pegged Asian currencies (and not just the renminbi). This would require an unlikely sweeping and coordinated change in policy in a number of Asian countries with different interests and constraints: with still fresh memories of the 1997-98 crisis, some Asian nations would be reluctant to moving into current account deficit and standing speculative financial flows in the appreciation process. Currency appreciation in Asia could result in greater financial instability if a small appreciation encouraged greater speculative capital flows into China and its neighbors, as well as if a large revaluation damaged the Chinese model of economic development (cf. Cooper 2005). The size of the expenditure switching effect is also questionable: dollar depreciation entails more expensive imports but with a significant share of US imports contributing towards the formation of US GNP (i.e., income earned by US companies abroad). As Kregel (2006) has stressed, an increasing portion of the US deficit reflects the existence of large foreign direct investment (FDI) by US companies as well as the imports of foreign affiliates selling in the US market: FDIs, outsourcing and the

globalization of international production may significantly reduce the impact of exchange rate adjustment on external accounts. In addition, if current account imbalances are primarily due to growth rates differentials, and if further dollar depreciation is likely to sustain, not reverse, such differentials, account imbalances are unlikely to disappear.

In conclusion, the effectiveness of correcting imbalances through a slowdown of demand in the US and currencies' appreciation in Asia is questionable, and the related risks seem considerable for the world economy, as well as for Euroland—as discussed in the next section.

The perilous navigation of the euro in the midst of global imbalances

Within the policy framework described above, where imbalances should be adjusted through US fiscal correction (on the debtor side) and more flexible exchange rates (on the creditor side), Euroland has hardly any role to play, and it may well remain on the sidelines. Indeed, within a (Classical) framework where the recipe for international balance is a combination of balanced-budgets, price stability and flexible exchange rates, then Euroland, with its overall nearly balanced position, should have little to fear from imbalances, and its current policy approach might as well be seen as a template for the rest of the world. Yet, arguably, Euroland cannot rely on its current set of policies for protection from a deflation in the US. The effects of a US deflation on the euro area would be that of creating further strains on economic and political cohesion: without a sustained increase in domestic demand, Euroland countries will continue to struggle over export shares, engage in 'beggar-thy-neighbor' polices, and further sustain deflation. Many European officials in Brussels and Frankfurt as well as many of their economic advisers may continue to

believe that the answer is to reform welfare systems as well as product and labor markets to reduce rigidities and increase labor force participation, but they cannot dismiss the risk of a dramatic new strain on Euroland if world growth came to an abrupt halt. Euroland has not so far proved to be mature enough to counter serious external challenges.

An equally risky scenario for Euroland, though considered by many as inevitable and even salutary, is the 'shock therapy' of a dollar drop. Euro appreciation reduces Euroland's international competitiveness and creates deflationary pressures, especially in those regions within the euro economy that remain largely based on exports. The outcome for the euro area could be particularly severe, given the lack of coordinated policy actions in the face of external shocks.

Would this conclusion modify if the euro could challenge the dollar's world dominance? Should the scenario prospected by Rubin, Orszag and Sinai materialize, and the dollar lose its world leadership, would the euro be capable to replace, or rival the dollar as the world key currency? A shift in currency portfolios would most likely (and problematically) cause euro appreciation. An appreciating currency, however, is not automatically a candidate to the key currency role in monetary relations, and a euro appreciation does not in any way imply that the euro might soon replace the dollar as the key world currency. In fact, the long dominance as the key world currency has not prevented the dollar from undergoing significant up and down movements, as portfolio allocation changed between US dollars, German marks, Swiss francs and Japanese yens, and largely in the interest of the US growth objective, as documented elsewhere in this volume. In the same fashion, the euro may well go through steep appreciation without fully or even partially replacing the dollar as the world monetary standard.

Exploring this aspect requires that the question of portfolio allocation be kept separate from the question of rivaling the dollar as the world key-currency. In fact, what we know of international currencies does not give much comfort to the possibility that the euro may soon replace the dollar and take world monetary leadership, as some fundamental conditions are missing. One should first distinguish a key currency (KC) from a high-hierarchy currency (HHC). In today's international monetary system, the dollar is the KC and a few other currencies that are heavily traded are HHCs. A HHC is a high-quality substitute in international portfolios that takes a prominent role as a share in private and official portfolios and may be used as a temporary safe-heaven investment in times of uncertainty and of cyclical depreciation of the KC. A HHC's perceived quality depends on the size and liquidity of its underlying money market, as well as by international reserve and/or current account surplus conditions (cf. Terzi 2006). By contrast, a KC is a currency that has international money status, i.e., it is used to settle international payments and is largely adopted as unit of account in international contracts. It is the currency with the highest degree of international 'moneyness'.

Generally, the conditions for a currency to be used internationally include a high exposure to trade and capital flows, a large domestic market, a large financial market, and economic and political stability. The dollar has all these features and also a characteristic that is strongly linked to the role of KC, namely, the largest and most liquid capital market. It may thus seem that the euro is close to be a credible challenger of the dollar. Yet, there remain five areas where the euro does not score well. One pertains to a lack of progress in what we described above as a decisive feature of a KC, namely the quality of the capital market: in this regard, the European capital markets remain largely fragmented and are still far from being competitive in

breath, depth, and liquidity with the US market (cf. Kregel 2000). A second area of concern regards inertia, a typical disadvantage of the challenger with respect to the incumbent: this requires that a new contender offer substantial advantages over the incumbent to stimulate switching.

The following three reasons pertain not so much to the list of characteristics that a currency must acquire to be a candidate to a KC role, but rather to the euro's lack of quality related to its 'supranational' character. First, as powerfully argued by Goodhart in this volume, the separation between political and monetary authority in Euroland implies the absence of provisions as well as of possible funding (by a non-existing euro federal treasury) of bailouts, and thus a risk of default of national debts no longer guaranteed by the national states is significantly higher. If the typically default-risk free investment medium of a currency area (consider the attractiveness of US government securities for private and official investors) is instead potentially risky and subject to investors' apprehension in response to news about government ratings and 'excessive deficit procedures', then the attractiveness of the euro as a KC inevitably suffers.

Second, the lack of a single decision-making body that implements macroeconomic governance, and thus aims at Euroland's growth damages the credibility of the euro: on this point, Cohen (2003) noted that in the euro economy 'in place of decisive management, market agents see fragmented decision making and a potential for chronic bickering.' And finally, as also noted by Cohen (2003), an anti-growth bias 'built into the institutional structure of the euro' has a negative effect on prospective rates of return on euro-denominated assets.

From these considerations, it seems that Euroland cannot at this stage escape from its original sin, that of a monetary union functioning with a largely incomplete

political union. Euroland has some features that permit to compare it with the US, such as economic size and price stability. Yet, there are other areas that put the euro at disadvantage in competing with the dollar as an official reserve asset as well as a denomination of international contracts.

This may have a dismal consequence. Should the dollar really collapse for reasons of a confidence crisis, the euro would be totally unprepared to replace it in its KC role. Not all too different from the old German mark, all the euro – as a HHC! – could really offer is a safe-haven for international investors, with likely deflationary consequences due to euro appreciation. Vulnerability to external shock, which was presumably eliminated by the creation of the single currency, inevitably re-emerge as a result of the missing federal economic policy. A problem of the euro seems to be indeed that it may continue to look like the German mark rather than the dollar.[10]

Considerations developed in the previous section suggest that a US demand drop or a dollar depreciation would both put Euroland under severe strain: the resulting slowdown in the demand for euro area exports would confront the euro economy with a deflation scenario. Likewise, a continuation of current imbalances does not seem favorable to the stability of the euro economy either. Having reached a size comparable to the US, Euroland still remains the sum of regional (national) economies, where national authorities and national policy actions of key individual members like Germany maintain a small open economy approach to their (now financially irrelevant) balance of payments, and where in case of difficulty they hope that the US market will bail them out. But while the US is unlikely to change its policy and Asia is in a good position to defend its current policy, the euro economy may soon find itself in a politically unsustainable situation: euro appreciation will have to be countered by downward adjustment of prices and wages to preserve

competitiveness, thus creating further pressure for euro disintegration (cf. Kregel 2006).

In sum, to address global imbalances from the standpoint of Euroland, there seems to be no alternative to a radical change in strategy towards policies that boost demand in slow-growth regions such as Japan, oil-exporting countries, and Euroland itself. With respect to Euroland, this might entail a profound review of current policy-making, well beyond the current emphasis on structural reforms.

Will the euro build its own identity and rival the dollar?

A critical review of the most prominent policies towards the challenge of 'global imbalances' reveals a vision of economic history whereby economies move on long-run paths and, when they temporarily deviate from long-run fundamentals, they ultimately converge back to trend and restore long-run equilibrium conditions. In this sense, a 'solution' to the question of international payments imbalances should entail a mere 'rebalancing' of payment flows, either through market mechanisms or 'sound policies'. This is in shark contrast with an alternative vision, whereby economic development is intrinsically tied with the emergence of imbalances. Throughout history, differences in growth rates, differences in the degree of openness to trade and financial flows, current account imbalances and other asymmetries have been the norm rather than the exception. Imbalances may continue unchallenged for long periods as long as they are in the interest of the parties involved. Indeed, 'imbalances' may be reversed not exclusively when they become unsustainable, but when growth patterns and national interests change. The current configuration, shadowing Keynes's mechanism, has allowed the widening of imbalances, at the cost of an increasing dependence on the US domestic market

conditions, and while leaving a significant economic region of similar size, namely Euroland, on the sidelines.

If the response to the risks posed by the current configuration of international payments imbalances is to prod adjustment on surplus regions, then, in the absence of an international mechanism managed by a multilateral system, candidates must be found among those who can afford the role of demand generators with no fear of engendering financial instability, and are willing, ultimately in their own best interest, to share with the US the 'burden'—and enjoy the benefits—of generating world demand.

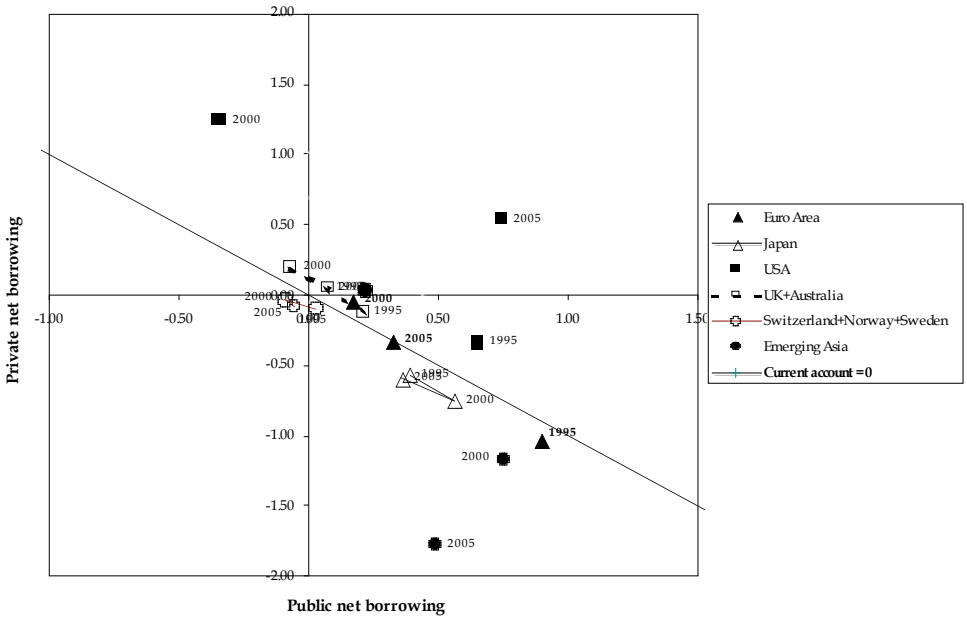
The way out for the euro and for 'global imbalances' could begin with Euroland exploiting the monetary power it has acquired with respect to the discontinued national currencies[11] in order to modify its character into a growth-generating region, and being open to dare into the right-side court in Figure 13.1. This requires more structural policies than the individual countries' initiatives can accomplish. Euroland's priorities should be those of completing single market integration and of proceeding towards a more centralized coordination of macroeconomic governance that pursue the missing goal of euro policies, namely domestic demand growth. This mission could be accomplished more effectively if the acquired prominent role of the euro were exploited in such a way that the euro economy becomes capable to be another 'world demand generator' in the global economy. This would entail being open to running external deficits as well as to exercise governance on the euro-dollar exchange rate.

If the euro proceeds along its current path, it cannot realistically aspire to play the role of a KC and will inevitably continue to play, willingly or unwillingly, the role of a temporary safe-heaven currency. It will remain more similar to the German

mark than to the dollar. Instead, adopting a system of macroeconomic governance, as warranted by its new currency, is one of those structural reforms that should be given priority in the interest of Europe. It would also provide an additional means to correct global imbalances through a policy of growth rather than deflation.

For Euroland to be part of the next round of trend changes in international financial flows, it should reconsider the role of its currency and reform its macroeconomic policy regime. The international challenge for the euro is to abandon its current role of a HC, inherited from the former German mark, before it can realistically play the role of a KC. One can envision the euro, injected into the world economy through current account deficits and/or a large-scale plan for development aid, acquiring a prominent role closer to that of the dollar. This could happen within a variety of arrangements including the setting of common growth and employment (and not only price stability) objectives to Euroland member countries, a centralized economic policy, and perhaps some degree of exchange rate coordination with the dollar (which is hard to envision in the present system where Euroland remains on the sideline of world demand generation). Priority to single market integration and further political union at the level of the euro area, and not necessarily at the broad EU level, may be needed too.[12] In any event, a new international identity of the euro requires that Euroland develop improved means of internal macroeconomic governance aimed at securing domestic demand growth and accept responsibility for global growth to be shared with the US. This is the tough economic and political challenge ahead.

Figure 13.1
Global financial imbalances
(% of world GDP)



Sources: IMF World Economic Outlook; Asian Development Bank Key indicators
Note: Emerging Asia includes People' Republic of Cina, India, Republic of Korea, Indonesia, Taipei China, Thailand, Philippines, Malaysia, Hong Kong China, and Singapore.

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[1] A list of 'true' global economic imbalances should include growing income inequalities, widespread and persistent unemployment, unequal access to financial resources, and considerable disparities in countries' vulnerability to external shocks.

[2] While in 1996 Milesi-Ferretti and Razin could still discuss current account sustainability with no reference to the US, three years later the scenario had changed. Amongst others, Blecker (1999, p.15) warned that the external position of the US was going to make the US dependent on international borrowing and vulnerable to international investors' portfolio decisions.

[3] Public sector net borrowing equals the public sector deficit, while private sector net borrowing is the difference between total expenses (including investment) and total receipts of all households and businesses (equal to the difference between investment and saving in the private sector).

[4] Incidentally, at the time of the Asian crisis, global accounts and Asian deficits in particular were much less unbalanced than they are today.

[5] For Dooley, Folkerts-Landau and Garber (2003) the current system is a 'revived Bretton Woods' system, reflecting a mutually beneficial two-way dependence between the US and Asia.

[6] This variety of the Classical view must assume that markets cannot be trusted to lead a timely, orderly adjustment.

[7] For a critique of the view that fiscal deficits in the US (or Euroland) cause rising interest rates, see Terzi (2007).

[8] On this point, Cooper (20005) has argued that 'any attempt to reduce the US deficit abruptly, other than through a spontaneous but unlikely surge in domestic investment in many other countries, would undoubtedly produce a world recession.'

[9] Paradoxically, critiques of Asian deficits as the supposed culprit of financial crisis in the late 1990s have turned into critiques of today's Asian surpluses.

[10] Rotondi and Vaciago (2002) find that private agents regard the euro 'as depending on the same fundamentals as the German mark" and suggest that 'the euro is the D. Mark in disguise.'

[11] Except for the German mark, pre-euro currencies could be seen as low-hierarchy currencies (at par with most Asian currencies today) constraining the viability of external deficits.

[12] In its pioneering role for full EMU in Europe, the euro area has a reason for paving the way to market integration and macroeconomic governance, even when other, non-euro EU countries may not feel the same urgency.