

## Correcting Global Imbalances with Exchange Rate Realignment?

### No thanks!

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**Global financial** imbalances have recently been fading from the headlines. One reason might be the strong growth performance of the global economy, for both developed and developing countries, despite signs of a mild slowdown in the United States. Another reason might be optimism about self-regulating market mechanisms, best represented perhaps by the views of the International Monetary Fund in the latest *World Economic Outlook* (April 2007, pp. 106):

*The analysis in this chapter of historical episodes of large and sustained imbalances and their reversal clearly suggests that a market-led realignment of real exchange rates can play an important complementary role to demand rebalancing across countries to facilitate a smooth unwinding of external imbalances.*

We cannot share, however, this optimism, particularly about the effectiveness of exchange-rate realignment. Global imbalances are much larger than ever before. The last instance of a widening U.S. deficit, in the mid-1980s, could be sorted out amongst a small club of rich countries. Yet, its correction took nearly four years, required a 30 per cent dollar devaluation and triggered a recession.

This time the current account of the U.S. is twice as large as its peak deficit of the 1980s (as a per cent of GDP) despite a 17 per cent dollar devaluation over the last five years. The counterpart surpluses are widely distributed amongst both developed and developing economies. Moreover, the size of global capital markets is many-fold greater than in the 1980s, with the consequence that the required currency realignment could have a major impact on the distribution of global wealth as well as income.

Using the Cambridge-Alphametrics Model (CAM),<sup>2</sup> a World Macroeconomic Model, to explore various policy scenarios, we conclude that exchange rate realignment in the current state of the world economy is close to a 'beggar-thy-neighbour' recipe, favourable, at best, to the United States (assuming no retaliation from other countries).

A real depreciation of the U.S. dollar *vis-à-vis* the currency of its trading partners at a rate of around five per cent per year would cause a slowdown of the world economy from about five per cent per year in 2006 to around two per cent in 2015. The U.S. economy slows down only from a trend rate of growth of three per cent to 2.5 per cent by 2015. But its current account deficit is reduced from its trend by less than one percentage point of GDP. Meanwhile, the rate of growth elsewhere in the world is cut. For the developing world, the reduction is from seven per cent per annum to just above two per cent.

If real depreciation in the U.S. is accompanied by real appreciation in the Asian region alone (Japan, China and the rest of Asia), the turn-around of deficits and surpluses would be more significant. Japan's surplus would be reduced in 2015, while the surpluses of China and

Figure 1: Current Account (\$ Bn.)

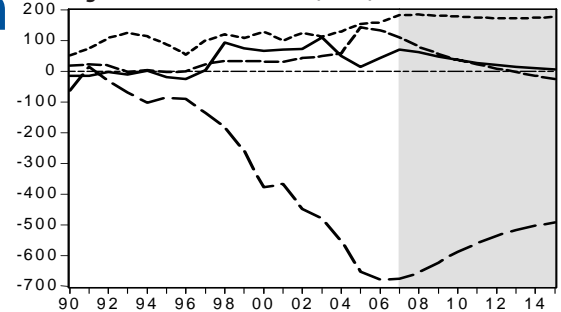
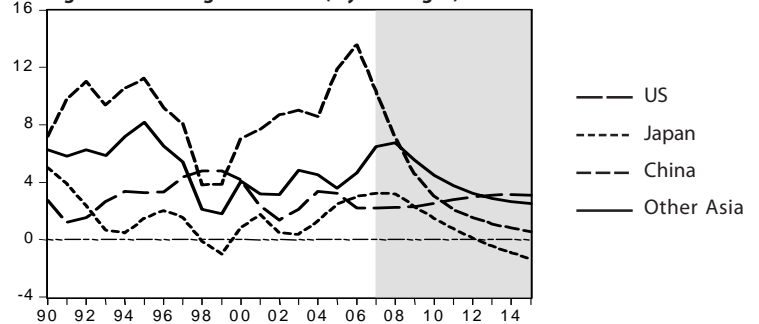


Figure 2: Annual growth rates (2 yr averages)



Asia would evaporate (Figure 1). However, Figure 2 shows that growth performance turns out to be much worse for Asia: there is recession in Japan, growth plunges to nearly zero in China and slows to about two per cent in the rest of Asia. However, the U.S. manages to regain its trend growth of about 3 per cent in about five years.

Of course, any model is only a rough approximation to a complex reality. So its results should be treated with caution. But it is not difficult to identify why there are likely to be such adverse outcomes from exchange-rate realignments. The reduction of net exports in the regions with appreciating exchange rates weakens their income growth; this effect reduces, in turn, their ability to import from the regions that experience exchange-rate depreciation. The net aggregate effect is that global income growth could be significantly slowed. The outcome could be worse if a corresponding disruption of capital markets causes volatility in investment.

Demand rebalancing, supported by the IMF as the complementary remedial measure, can in principle provide a more effective and mutually beneficial solution. The growth of domestic demand would have to slow in the U.S. while it increased in countries with current-account surpluses. But this would require a degree of coordinated international efforts that is unlikely to occur as long as international financial institutions continue to believe in the magic of market mechanisms. They cannot acknowledge the prospect that current mammoth global imbalances could result in an abrupt, drastic and mutually destructive correction.

#### References:

1. Director, Alphametrics Co., Ltd; Visiting Scholar, Cambridge Endowment for Research in Finance, University of Cambridge; Acting Director, International Poverty Centre, Brasilia.
2. The model has been developed by the Cambridge Endowment for Research in Finance and Alphametrics from an original version created by the Cambridge Economic Policy Group in the early 1980s. Its development has been supported by the International Poverty Centre, Brasilia. A detailed account of the model can be found in Cripps, Izurieta and McKinley (2007), 'Developing a global model for trade, finance and income distribution', *IPC Technical Paper No.1*, February. See IPC Research Programme, [The State of the World Economy](#).