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A healthy global economy begins at home
By Kenneth Rogoff

The US Treasury tried to walk a legal tightrope this week. In its biannual foreign exchange report to Congress, it declared that while China is not yet guilty of exchange rate manipulation, it will soon become guilty unless it changes its policy. What exactly does this mean? Too many lawyers must have worked on this phrasing, which rivals Bill Clinton's famously evasive line (in response to a question under oath about whether he was having an affair) "It depends on what the meaning of 'is' is." To be fair, the Treasury report is very thoughtful overall, aimed at mollifying trade protectionists in Congress who are proposing punitive tariffs on Chinese imports unless Beijing stops intervening to hold the renmimbi down against the dollar. The report rightly aims to deflect attention from US-Chinese trade by focusing on the way that China's current dollar peg blocks an important price mechanism from helping to unwind today's massive global trade and current account imbalances.

Of course, what the Treasury report does *not* say is that "global imbalances" is a euphemism for "US borrowing binge." After all, America is now absorbing 75 per cent of the current account surpluses of the world's surplus countries, not just China. Nor does the report mention how extraordinarily lax US monetary and fiscal policies of the past few years have probably played a far bigger role than China's peg in exacerbating the problem. Now that the US recession has passed, the starting point for reducing global imbalances has to be faster macroeconomic policy normalisation in America. The report spews the official line that the government is already reducing its own fiscal deficit. But the official target of a 50 per cent deficit reduction by 2009 is hardly ambitious enough, even if it were fully credible. Monetary policy, too, needs to compensate for years of low interest rates that have fuelled an increasingly speculative housing price boom, which has in turn contributed to low personal savings and a bigger current account deficit.

But China's exchange rate policy also matters. Indeed, it is hard to see any scenario for unwinding the global imbalances in which Asian currencies do not appreciate sharply against the dollar. According to my latest paper* with Maurice Obstfeld, a halving of the US current account from 6 to 3 per cent of gross domestic product over two years would lead to an 18 per cent appreciation of Asian currencies versus the dollar, with China being on the high side. Eliminating the global imbalances would entail a proportionately larger appreciation (35 per cent) of Asian currencies, and a 10-20 per cent appreciation of major non-Asia currencies including the pound and the euro. If, however, Asia sticks to its dollar peg, Europe gets slammed by massive currency appreciation and massive current account deficits. For good measure, Europe suffers the double whammy of huge (15 per cent of European GDP) capital losses on its dollar and Asian currency assets. Asia's surpluses actually grow in this scenario, as they must to maintain Asia's dollar pegs in the face of an improving US current account.

We have talked about China's contribution to smooth global adjustment in the face of massive US borrowing, but what policy is best for China? It is a very tough question, not least because China is really two economies rolled into one. Wealthy coastal China has 450m people living in a vibrant emerging market. But the rest of China, particularly the agricultural sector, has 750m still living in a poor developing country. Many outside observers estimate China's rural unemployment at over 150m people. Poor developing countries typically do well with relatively fixed exchange rates, whereas emerging markets typically need more flexible ones. On balance, given that China's future lies with greater globalisation not less, authorities should probably move very soon to a more flexible exchange rate, while the pressures are towards appreciation and relatively easy to handle. An initial step appreciation accompanied by a move to a managed float would seem to be the ticket. But the urgency of the situation really comes from the need for China to take a lead role in dealing with a global problem. In the meantime, the US Treasury ought to focus its next report on getting the country's own fiscal house in order.

**Global Current Account Imbalances and Exchange Rate Adjustments; www.economics.harvard.edu/faculty/rogoff/papers/BPEA2005.pdf*

The writer, a former chief economist of the International Monetary Fund, is professor of economics at Harvard University.