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EUROPEAN PERSPECTIVES ON GLOBAL IMBALANCES

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European Perspectives on Global Imbalances

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Abstract

The large and growing US current account deficit has its counterpart in the large and growing current account surpluses in Asia and in the major oil-exporting countries. Although Europe is not part of the problem of global imbalances, Europeans are concerned that a disproportionately large burden of adjustment will fall on Europe. Without more exchange rate flexibility in Asia, adjustment may involve excessive appreciation of European currencies. The euro-area economy is not flexible enough to cope easily with a substantial euro appreciation, which would depress already sluggish growth and exacerbate divergences within the euro area. If EU institutions do not deliver in the face of a sharp appreciation in the euro, Europe's responses could be more erratic, and there would be a greater risk of a more protectionist response.

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1. Introduction

Global current account imbalances have widened markedly in recent years amid a configuration of robust growth, fiscal deficits, and low personal saving rates in the United States, sluggish growth in Europe, high savings rates and export-led growth in Asia, and elevated oil prices that have boosted the coffers of oil-exporting countries.

This paper explores the issue of global current account imbalances from the perspective of European countries. We have divided the paper into six sections. After this brief introduction, we discuss the role that Europe has played in the development of global imbalances. Data on current account balances suggest that Europe is not part of the problem of global imbalances. From Europe's point of view, the optimal global rebalancing scenario is one in which Europe imports more US-produced goods and services and exports more goods and services to Asia and the oil-exporting countries, leaving Europe's current account largely unaffected even as the US current account deficit shrinks. However, this outcome presupposes a decline in the Asian current account surplus, which likely will require appreciation of Asian currencies. Europeans fear an alternative rebalancing scenario in which Europe imports more from the US and exports less to Asia or imports more from Asia, allowing the US current account deficit to decline while the Asian surpluses remain the same. This undesirable outcome for Europe is most likely to result if Asian currencies remain pegged to the dollar, which in the event of a drop in the dollar, could lead to an excessive real appreciation of the euro.

In the next section, we explore the consequences of a substantial real exchange rate appreciation for Europe. We highlight several reasons why an excessive

appreciation of European currencies would be a serious concern in Europe, including the depressing effects on European economic growth, the inability of some European economies to adjust smoothly and promptly to an exchange rate shock, and the effects on divergences within the euro area. This section also includes a discussion of the implications for Europe of changes in exchange rate regimes in Asia.

We next discuss the roles that European institutions might play during global current account adjustment. If a sharp adjustment in exchange rates were to occur that threatened to result in deflationary pressures in the euro area, the ECB would be expected to loosen monetary policy promptly and aggressively. The jury is still out, however, on the ECB's deflation-fighting zeal. We also highlight how Europe's Stability and Growth Pact may hinder a prompt response of fiscal policy to a rapid adjustment. In addition, we explore the possibility of European intervention in foreign exchange markets as a response to an excessive appreciation in the euro.

European attitudes and policies vis-à-vis Asia are examined in the next section. The large US current account deficit and large Chinese current account surplus raises a question about what is driving this China-US imbalance. One view puts the blame on US excess demand while another view points to excess savings in China. Depending on which one it is, reducing that imbalance has different consequences for relations between China and the euro area. We close with a summary of the paper and some recommendations for policy.

2. Europe's contribution to global imbalances

Data on the evolution of external balances, shown in Table 1, suggest that Europe contributes very little to current global imbalances. The counterpart of the large and growing U.S. current account deficit are the large and growing current

account surpluses in Asia and in the major oil-exporting countries. Over the past decade, the nearly $700 billion increase in the US current account deficit was accompanied by a roughly $330 billion increase in Asia's surplus and a $360 increase--most of which happened since 2002--in the oil-exporters' surplus. For 2005, the US current account deficit of nearly $800 billion is almost entirely accounted for by Asia's roughly $400 surplus and the $375 billion surplus of the oil-exporting countries.

In contrast, the euro area's current account (measured in a way that corrects for reporting discrepancies in intra-area transactions) swung into deficit last year, following 3 years of moderate surpluses. The UK current account deficit continued to widen, reaching $58 billion (about 2½ percent of GDP) last year. One reading of these data is that Europe is not part of the problem of global imbalances. This is not withstanding the fact that some euro-area countries have sizable current account imbalances: Germany, for example, has recorded annual surpluses of around $100 billion in recent years. As an aggregate, however, the euro area seems to be financially largely self-contained. Taking the EU as an aggregate, this tendency is even stronger. This suggests that the eventual rebalancing of current accounts should primarily involve the US, Asia, and the oil-exporting countries.

The whopping current account surpluses registered in oil-exporting countries in recent years highlight an interesting consequence of the ongoing elevated level of world oil prices for global imbalances: High oil prices have shifted some of the rest of the world's (that is, non-US) current account surplus away from Asia towards net oil exporters. To the extent that the oil-exporting countries have lower propensities to save than economies in Asia, this shift may bring about a faster decline in savings in the rest of the world. That said, Asian economies also have higher investment rates

than those in oil-exporting countries. Therefore, it is not clear whether the shift in surpluses from Asia towards oil exporters will slow or speed up current account adjustment. Moreover, because oil-exporting countries have lower savings and investment rates than economies in Asia, recent developments imply a shift in global demand away from investment goods and towards consumption goods. This might well benefit US exports (which are more heavily concentrated in consumer goods and services) at the expense of German exports (for which capital goods are more important).

Underlying Europe's current account deficit for 2005 were the bilateral trade balances reported in Table 2. Europe's trade surplus with regards to the US of nearly $100 billion last year was similar in magnitude to the trade surpluses of both Japan and the oil-exporting countries against the US, and roughly half the size of China's surplus with the US. Like the US, Europe recorded large bilateral trade deficits vis-à-vis China, Japan, and the oil-exporting countries. Although the configuration of bilateral trade positions reflects many factors, one can imagine a global rebalancing scenario in which Europe imports more US-produced goods and services and exports more goods and services to Asia and the oil-exporting countries. This would leave Europe's current account largely unaffected even as the US current account deficit shrinks, but it presupposes a decline in the Asian current account surplus. The alternative rebalancing scenario is one in which Europe imports more from the US and exports less to Asia or imports more from Asia, allowing the US current account deficit to decline while the Asian surpluses remain the same.

The financial counterpart to the large current account imbalances are the large imbalances in net international financial flows. Another perspective on global

imbalances can be gained from exploring what role Europe has played in generating the observed patterns in financial flows.

Table 3 shows data on the composition of US capital flows over recent years. A striking feature of recent capital flows has been the substantial rise in official net capital flows since 2001. These net inflows peaked in 2004 as the authorities in Asia intervened heavily in foreign exchange markets in an effort to restrain the appreciation of their currencies, before moderating some last year.[1] The step-down in net official inflows in 2005 compared with the previous year, as well as the sharp increase in net private inflows, meant that the bulk of the overall net inflows needed to finance the US current account deficit last year was accounted for by net private capital inflows. By contrast, in both 2003 and 2004, net official inflows were the predominate source of financing, accounting for 60 per cent of total net inflows in 2003 and 65 per cent in 2004. Most of these flows came from Asia; Europe is not part of the official flows story.

Interestingly, Feldstein (2006) argues that in reality foreign governments continue to provide the overwhelmingly share of financing for the US current account deficit, and that a substantial chunk of inflows that are classified as "private" in the balance-of-payment data are purchases of US securities by private institutions acting on behalf of foreign governments. Whatever the truth, there is little doubt that official inflows have become a significant source of financing for the US current account deficit.

The rise in net private inflows last year in part reflected the continued recovery in the demand for claims on the US private sector from their recent lows in

[1] The Japanese Ministry of Finance reported record levels of foreign exchange market intervention during 2003 and 2004, with total intervention amounting to the equivalent of $183 billion in 2003 and $136 billion in the first quarter of 2004. No official intervention by the Japanese authorities has been reported since the first quarter of 2004.

2003. Private foreign purchases of US securities (excluding US Treasury securities) jumped last year, largely reflected a marked increase in private foreign purchases of US corporate bonds, though purchases of US equities and US agency bonds also rose. Figure 1 confirms the findings in Lane and Milesi-Ferretti (2005) that foreign purchases of US debt (including corporate bonds, agency bonds, and Treasuries) have become an increasingly important source of financing of the US current account deficit in recent years relative to purchases of portfolio equities and direct investments.

Private foreign purchases of US Treasury securities also rose last year. Table 4 shows that the increase in purchases in 2005 was broad-based across foreign regions.[2] The largest private purchasers of US Treasury securities last year were from Europe, followed by the Caribbean financial centers (perhaps partly reflecting purchases by the oil-exporting countries) and Asia.

In addition, although private foreign direct investment in the US declined $23 billion last year relative to 2004 (see Table 3), US direct investment abroad plummeted from $244 billion to $9 billion as foreign subsidiaries of US multinational corporations repatriated large amounts of funds back to the US in response to incentives associated with the American Jobs Creation Act of 2004, that expired for most companies at year-end 2005.

Europe's contribution to capital inflows into the US is summarized is Table 5. US capital inflows from Europe peaked at nearly $600 billion in 2000 in the midst of the US high-tech bubble. The pace of inflows from Europe slowed sharply over the next two years, but recovered in 2004 and 2005 to more than a $450 billion annual rate.

[2] The aggregate figure for private foreign purchases of US Treasury securities in Table 4 of $215 billion differs from the $200 billion figure reported in Table 3 because the former excludes not just central banks and finance ministries but transactions of all foreign official agencies.

This recovery was driven in large part by increases in European purchases of US private securities, which were especially large in 2005 at $220 billion. As shown in Table 6, UK purchases of US corporate bonds ballooned in 2005 to $140 billion from about one-half of that amount in 2004. In contrast, inflows of direct investment from Europe (see Table 5), which tanked in 2001 from the rapid pace of the late 1990s and 2000, has remained subdued at about a $65 billion annual pace.

Is there "Dark Matter" in European-US investment?

It is well known that although the US has had a large negative net international investment position (NIIP) for many years, US income receipts have been larger than income payments.[3] At end-2005, for example, the US NIIP stood at -$2.7 trillion (about 25 per cent of US GDP), while income receipts at $474 billion outpaced payments of $463 billion for the year as a whole.[4] Recently, Hausmann and Sturzenegger (2005) generated quite a bit of controversy by attributing the positive net income flow to so-called "dark matter" in the balance-of-payments statistics.[5] Their claim is that US direct investment abroad contains intangible assets that are not measured in the statistics. As a result, US FDI abroad is undervalued.

Table 7 sheds some light on the question of "dark matter" from the perspective of Europe. Over recent years, US income payments to the EU have slightly exceeded US income receipts, typically to the tune of about $8 billion. However, US income receipts on direct investment in the EU has exceeded US income payments to EU direct investment in the US. The difference between US receipts and payments on its FDI position vis-à-vis Europe rose from $16 billion in 1999 to around $32½ billion in

[3] See, for example, Cline (2005).
[4] US income payments actually exceeded receipts in the fourth quarter of 2005 and the first quarter of 2006, in part reflecting the higher interest payments on US bonds and notes as a result of rising US interest rates.
[5] Buiter (2006), for one, is not convinced.

2001 and 2002, before easing back to about $13 billion in 2005. This difference between receipts and payments persisted despite the fact that the stock of US direct investment in Europe was less than or only slightly exceeded the stock of European direct investment in the US. Whatever the source of "dark matter" in recorded US income flows, Europe appears to be part of the story.

How will the burden of adjustment be shared?

The net financial inflows to the US described above add to US net external liabilities. As discussed in Ahearne and von Hagen (2005), the trend of rising US net external liabilities relative to GDP cannot continue forever. A continuously rising ratio of net external liabilities to GDP would eventually see the burden of servicing these liabilities becoming unbearably large. At some stage, the ratio of net external liabilities to GDP must stabilise, which requires that the US trade deficit eventually narrow to near zero. The adjustment will almost certainly involve a significant real depreciation in the real effective exchange rate of the dollar (a weighted average of bilateral real exchange rates). Given that the responsiveness of US exports and imports to changes in the real effective exchange rate is relatively small, substantial real dollar depreciation, perhaps in the range 20-40 per cent, will be required to shrink the US trade deficit.[6]

When the real effective exchange rate of the dollar depreciates, the key factor determining how the burden of adjustment is shared across countries will be movements in bilateral exchange rates. Europeans are afraid of an unfair distribution of the adjustment burden because their exchange rates are the only flexible things around. Figure 2 shows that the bilateral dollar-euro and dollar-sterling nominal

[6] Estimates of the amount of dollar depreciation that may be required to bring about adjustment are from Blanchard, Giavazzi and Sa (2005) and Obstfeld and Rogoff (2004).

exchange rates have moved much more over recent years that the US nominal effective exchange rate, suggesting that a large amount of the effective dollar depreciation since 2002 has been borne by Europe. Unless something changes, Europeans are fearful that this unequal distribution of adjustment will continue.

Figures 3-5 help us to think about the implications of some of these issues by offering a longer-term perceptive on current account balances in the major regions. Figure 3 shows current balances since 1980, which allows us to compare the current imbalances with the past. Figure 4 reports the cumulated current account imbalances over time. It shows how much US assets each region has accumulated. Figure 5 shows the cumulated current account of each region as a percentage of the cumulated US current account. It shows the share of dollar assets that each region had acquired up to that point. A negative number means that a region is a net acquirer of dollar assets.

A first, consistent message from these graphs is that the EU has been largely a self-financing region over the past 25 years. Current account imbalances have never been very large. For Europe to shoulder a major part of the new adjustment would be an unprecedented experience. To put it differently: Europeans have never accepted large changes in Europe's current account position to allow global adjustment. The only exception is the brief period between 1986 and 1988, when Europe tolerated a moderate shrinking in its current account surplus, coinciding with the period in which international coordination worked (i.e., over the period from the Plaza to the Louvre agreements).

A second, interesting part of the message is the stark difference between the 1980s imbalances and today's. In the 1980s, Japan contributed most of the adjustment and acquired most of the dollar assets. In recent years, the adjustment has been shared more equally among the Asian economies. In contrast to the 1980s, there is now a

coordination problem on the Asian side. That is, in the 1980s, any externality from the adjustment (the fact that stopping support for the dollar would have consequences for the home-currency value of the previously accumulated dollar assets) was internalized by Japan. This is no longer the case. This may be one reason why developing Asia and Japan seem to go in different directions since 2004, with an increasing share of the action being official interventions: As Japan slows its support for the dollar, developing Asia increases its support in fear of a falling value of the dollar.

This is interesting from a European perspective. In the 1980s, the Europeans were dragged into the Plaza Agreement (against opposition, especially from the Bundesbank) because the US and Japan were able to reach an agreement. Now the situation is different: It would take the US and many Asian economies to coordinate before Europe could be coerced into a similar exercise.

Continuing the same logic suggests that Europe has little interest in promoting international coordination with the Asian economies and the US. Europe would prefer to hide behind the argument that the ECB is independent and cannot be forced to cooperate.

3. Consequences of real exchange rate appreciation for Europe

There are several reasons why an excessive appreciation of European currencies would be a serious cause for concern in Europe. For starters, notwithstanding recent indicators suggesting a nascent recovery in the euro area may be underway, economic growth in the euro area remains sluggish. A disproportionately large real appreciation of the euro that depresses euro-area net exports could snuff out any prospect of a long-awaited improvement in economic performance. Second, euro-area markets for labour and products are not sufficiently

flexible to facilitate the smooth reallocation of resources across sectors that would be required to keep unemployment from rising in the event of a large euro appreciation. Finally, a significant appreciation in the euro would have asymmetric effects on individual euro-area members and would add to already sizable divergences in economic performance across the euro area. We now discuss each of these reasons in more detail.

Economic growth in the euro area has been very disappointing for a long time, dragged down by dismal real GDP growth in some of the larger EMU countries such as Germany and Italy. Recent indicators on activity have been more positive, but it is not clear whether the recent pick-up in growth in domestic demand can be sustained. As a result, a sharp appreciation in the real exchange value of the euro that would depress net exports carries with it the risk of deflationary pressures and a severe recession in the euro area. Adjustment could be very painful if accompanied by higher euro-area inflation since this would rule out monetary easing by the ECB. In this regard, one concern is that the recently elevated rates of growth in euro-area monetary aggregates may lead to a pick-up in inflation in the next year or two, possibly at the same time that the euro is appreciating.

Moreover, as holders of large amounts of dollar assets, a sharp appreciation in the euro versus the dollar might also have a depressing effect on domestic demand in the euro area as a result of negative wealth effects. As shown in Table 8, the euro area's holdings of gross dollar assets at the end of 2004 amounted to nearly $3,000 billion, equivalent to about one-third of euro area GDP. Depreciation in the dollar of 30 per cent against the euro would imply a loss of wealth for the euro area equal to nearly 10 per cent of euro area GDP. This is a large number, although given uncertainties about the true size of wealth effects in Europe, it is an open question as

to how large the effect on domestic demand would be of a loss of wealth of this magnitude.[7]

These numbers assume an orderly adjustment. The wealth effects of a disorderly correction would be even greater. Such a scenario would not only involve an abrupt drop in the dollar, but would also see surging US interest rates, falling US stock prices, and weaker economic activity in the United States. The effects would probably spill over into financial markets in other countries, dragging down asset prices in Europe and elsewhere.

A second major concern is that markets in Europe are not sufficiently flexible to facilitate the smooth reallocation of resources that real exchange rate adjustment would necessitate. Ahearne and von Hagen (2005) present estimates of the possible effect on Europe's already high unemployment rate based on a scenario where the burden of adjustment is shared equally between Europe, Asia and the oil-exporting countries. In that example, adjustment would result in more than 3 million job losses in Europe's traded goods sector. If these displaced workers were not able to find new jobs in the non-traded sector, the average EU-15 unemployment rate would jump to 9 per cent from 7.5 per cent today, increasing the fiscal burden of unemployment accordingly.

To keep unemployment from rising, significant resources would need to shift from the traded goods sector to the non-traded sector. It is not clear that European markets are flexible enough to engineer such a large reallocation, especially if adjustment occurs over a short period of time. To be sure, the US has successfully moved factors from its traded goods sector to its non-traded sector to keep the US economy close to full employment as the trade deficit has swelled. However, US

[7] We note that the euro depreciated about 40 per cent against the dollar between 1999 and 2002, and then appreciated about 50 per cent afterwards with no apparent wealth effects, perhaps suggesting that wealth effects in the euro area are small.

markets are generally regarded as more flexible than European markets, and the reallocation in the US has taken place gradually over a decade.

A third reason why an excessive appreciation of the euro would be a serious concern for Europeans is that it could exacerbate the problem of economic divergences in growth and inflation between existing EMU members (for a discussion of divergences in the euro area, see Ahearne and Pisani-Ferry, 2006). A sharp appreciation in the euro would represent a common shock to countries in the euro area, but one that would probably have asymmetric effects on individual euro-area members. These asymmetric effects would complicate the response of policy to the rise in the euro, especially the response of the euro area's one-size-fits-all monetary policy. These effects could be alleviated, however, by a shift in demand towards the oil exporting countries, if these countries buy primarily investment goods in Europe. In that case, a large share of the extra demand would fall on Germany and help the adjustment.

Appreciation in the euro would probably have asymmetric effects on individual countries in the euro area for several reasons. First, as shown in Table 9, the importance of trade with the United States varies considerably across euro-area countries. Exports to the US in 2005 represented less than 1 per cent of GDP in Greece and Spain. At the opposite end of the scale is Ireland, where exports to the US accounted for a whopping 10 per cent of GDP last year. Ireland also imported a relative large share from the United States, along with other countries such as Belgium and the Netherlands. In contrast, imports from the US were relatively small for Finland, Spain and Portugal. As a result, the size of the effect of movements in the euro on individual countries' real effective (trade-weighted) exchange varies

considerably.[8] In addition, some industries would be affected more than others by euro appreciation, so differences in industrial structure and the composition of trade with the US will cause asymmetric effects.

More generally, in the context of a Chinese currency pegged to the dollar, the relevant trading partner is not just the United States, but the wider "dollar zone" of countries whose currencies would depreciate along with the dollar. All euro-area members have seen their imports from China rise markedly since the launch of EMU, with Belgium and the Netherlands importing the most from China.

As well as different trading patterns, asymmetric effects of a sharp appreciation may arise because of differences across euro area members in trade elasticities, initial conditions, investment patterns, and flexibility.

Implications for Europe of exchange rate regime change in Asia

Currency regimes in Asia continue to receive a great deal of attention from policymakers and the press around the world. The United States, for example, has been a strong advocate for a more flexible exchange rate system in China. European policymakers, fearful that Europe may have to bear a disproportionately large share of the adjustment of the US external position, obviously have a keen interest in this debate. So far, the response of euro-area policymakers has been to make the sensible suggestion that other countries, whose bilateral dollar and effective exchange rates have not appreciated over the past few years, and in many cases have depreciated in effective terms, should allow their currencies to adjust.

Since adjustment will involve depreciation in the US real effective exchange rate, the question arises: To what extent will governments in Asia allow their

[8] See Honohan and Lane (2004) for a discussion of how exchange rate movements affect inflation divergences within the euro area.

currencies to appreciate? Especially important in this regard is China's exchange rate regime. China in particular has pegged its currency firmly to the US dollar for many years. In July 2005, the renminbi was allowed to appreciate about 2 per cent, and has been stable since. China's government announced that, in the future, it would peg to a basket of currencies, but the exact composition of this basket remains unspecified. Future adjustments in China's exchange rate policy have two dimensions that are relevant for Europe. One is the level of the exchange rate. The more the renminbi is allowed to appreciate against the dollar, the larger the part of the US current account adjustment that falls on the trade flows between China and the US, and the less need there is for adjustment between the US and Europe.

The other dimension is the exchange rate regime. The more the Chinese peg shifts from the dollar to the euro, the more China will become a net buyer of euro assets. This is likely to result in a euro area current account deficit vis-à-vis China, and an appreciation of the euro's real exchange rate, thereby weakening euro area exports. Europe therefore has a clear interest in a significant appreciation of the renminbi against the dollar, but not in an increase in the euro's share in the currency basket to which the Chinese peg their currency.

From a European perspective, a key consideration revolves around what might happen to the foreign exchange value of the euro versus the dollar should China move to a floating exchange rate regime, as some observers are advocating. On the one hand, if China's moves to a floating system, Chinese demand for dollar assets will drop, eliminating a major source of demand for dollars. As a result, the dollar might be expected to drop against the euro. On the other hand, to the extent that the renminbi appreciates against the dollar under a Chinese float (as most observers would expect),

then the euro may not have to play as large a role in bringing about the necessary drop in the real effective dollar to close the US trade deficit.

4. The response of European institutions

A crucial question for Europe revolves around the ability of European institutions to cope effectively with an exchange rate shock. Whether or not these institutions can deliver in the face of a sharp exchange rate adjustment obviously matters enormously for Europe, but it also has important implications for Asia: If EU institutions do not deliver, Europe's responses could be more erratic, with an increased risk of a more protectionist response. In this section, we briefly discuss the role that EU institutions will play during global current account adjustment and outline the main open questions concerning the likely effectiveness of the current arrangements in Europe.

If a sharp adjustment in exchange rates were to occur that threatened to result in deflationary pressures in the euro area, the ECB would be expected to loosen monetary policy promptly and aggressively. One issue is the extent to which a rise in the value of the euro passes through into imported prices. If exporting firms price-to-market, then an appreciation of the euro will squeeze the profit margins (after being converted into euros) of European firms exporting to the US, but the (euro) price of imports from the US will not the affected. As a result, the dampening effect on inflation of lower import prices will be absent, possibly ruling out aggressive ECB actions.[9]

Moreover, the experience in 2001 when the ECB showed a pretty subdued reaction to the risk of deflation, at least compared with the Federal Reserve, raises

[9] Estimates of pass-through in the euro area are provided in Faruqee (2004), Warmedinger (2004), and Brissimis and Kosma (2005).

questions about how quickly and forcefully the ECB would respond to a large exchange rate shock. For example, by the time of the first ECB interest rate cut in mid-2001, at which time the policy rate was trimmed 25 basis points to 4½ percent, the Federal Reserve had already carried out 250 basis points of easing. As a result, in mid-2001 real interest rates in the euro area, at about 2 per cent, were almost double the level in the US.[10]

National governments would also play a part in responding to adjustment. A fiscal expansion in Europe can mitigate the effects of the decline in aggregate demand resulting from the US current account adjustment. Ahearne and von Hagen (2005) recommend that to facilitate this response without endangering the sustainability of public finances in the EU countries, governments should move their budgets to balance or small surpluses now. An additional benefit of these sound policies would be to make European assets more attractive to Asian investors. But the story here is more complicated. The Stability and Growth Pact (SGP) might hinder a sufficiently strong fiscal reaction, especially one that would be forward-looking in the sense of acting quickly when the dollar declines fast. Furthermore, if the ensuing recession is asymmetric across countries within the euro area, there may be more tension in the European Council between the countries strongly affected that desire a large fiscal response and those less affected that will insist on staying within the SGB limits. Some commentators have argued that the European Commission might be slow to provide the leadership necessary in such situations. Again, this may result in delayed responses.

[10] ECB President Trichet recently offered a different point of view, arguing that central bank "activism" cannot be quantified by simple statistics such as the frequency and size of policy moves, and that the "ECB's strategy is as active as it needs to be to fulfil our mandate." (Trichet, 2006)

Another possible policy response in Europe to a perceived excessive appreciation in the euro would be intervention in the foreign exchange market.[11] According to EMU Treaty, responsibility for exchange rate policy is divided between the Council of Ministers and the ECB.[12] The Council chooses the exchange rate regime under certain provisions (see the footnote below) and subsequently the national central banks in the euro area carry out the interventions. Since a formal agreement to peg the euro to the dollar is unlikely, this division of responsibilities is not of major relevance. That said, the Treaty does give the Council power to "formulate general orientations for exchange rate policy."[13] It is unclear at this stage how the Council might use this power in the event of an excessive exchange rate shock.

Although the ECB decides on all details of intervention, in the only episode of ECB intervention to date--the intervention in 2000 to support the euro--the ECB chose to consult with the Eurogroup of euro-area finance ministers. ECB officials stressed at the time, however, that the ECB does not need finance ministers' permission to intervene in foreign exchange markets.[14] Henning (2006) argues that intervention is unlikely to be successful if finance ministers were to publicly oppose it. However, in the case of global adjustment, the situation is likely to be the opposite from what it

[11] Henning (2006) provides an interesting account of the European intervention in the foreign exchange market to support the euro in the autumn of 2000. Howarth and Loedel (2003) also discuss the institutional arrangements relevant for foreign exchange intervention in the euro area.

[12] Article 111, paragraph 1 of the Treaty of Amsterdam states that "By way of derogation from Article 300, the Council may, acting unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, after consulting the European Parliament, in accordance with the procedure in paragraph 3 for determining the arrangements, conclude formal agreements on an exchange rate system for the ECU in relation to non-Community currencies.

[13] Article 111, paragraph 2, states that "In the absence of an exchange rate system in relation to one or more non-Community currencies as referred to in paragraph 1, the Council, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, may formulate general orientations for exchange rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability."

[14] See, for example, ECB President Duisenberg's comments reported in The Financial Times, "Careful planning behind banks' euro surprise," 24 September 2000.

was in 2000: The finance ministers may want intervention (to stem the appreciation of the euro) but the central bankers may be opposed.

The relationship between European institutions and the effectiveness of arrangements in the euro area also comes into focus in the context of the new IMF multilateral consultations on global imbalances. The consultations began in summer 2006 (initially on a bilateral basis with IMF staff) and involve China, the euro area, Japan, Saudi Arabia, and the United States. Reportedly, the euro area's representation consists of the Eurogroup, the ECB, and the European Commission. Munchau (2006) argues that recent squabbling between ECB president Trichet and Eurogroup president Juncker augurs badly for effective coordination between European policymakers. More generally, Berès (2005) argues that there was no "sign of solidarity" in the euro area when the euro appreciated markedly vis-à-vis the dollar in 2003.

5. European attitudes and policies vis-à-vis Asia

The large US current account deficit and large Chinese current account surplus raises a question about what is driving this China-US imbalance. One view puts the blame on US excess demand while another view points to excess savings in China. Depending on which one it is, reducing that imbalance has different consequences for relations between China and the euro area.

The "capital-flows" or "global saving-glut" view of global imbalances points to the high (and growing) level of national savings abroad, especially in Asia, as the factor responsible for the large (and growing) US trade deficit.[15] This raises the

[15] See Bernanke (2005).

question as to why national savings are so high in Asia. There appear to be several reasons.

For starters, Asian countries seem hungry for dollar assets as they desire to rebuild - and even expand beyond - the net foreign asset positions they enjoyed before the financial crises of the late 1990s, in order to protect themselves against future financial turbulences and dependence on IMF support.

Additionally, reserves are being accumulated in the context of foreign exchange interventions intended to promote export-led growth by preventing exchange-rate appreciation.[16]

Furthermore, these countries face growing demographic problems. Given the absence of well-developed social security systems in most Asian countries except Japan, they may want to accumulate net foreign assets as a source of income for their rapidly ageing populations. If this is the case, the US is just supplying the assets that Asians want, and this arrangement could go on for some time with no need for an immediate, sharp adjustment. Eventually, however, the "capital flows" view suggests that the US capital account will have to balance and the current account with it.

Importantly, Europe's demographic problems are of the same kind as Asia's, though Europe has a bit more time to reach the peak in the old-age dependency ratio. This suggests that from the point of view of Asian investors, Europe is not a good region from which to buy assets. Hence, if the Asian-US imbalance goes away, a similar imbalance is unlikely to emerge between Europe and Asia.

The "excess-savings-in-Asia" view implies a different picture. If Asian savings are high for reasons other than ageing, a closing of the US current account deficit would imply a widening of Europe's current account deficit.

[16] Dooley, Folkerts-Landau, and Garber (2004) present a controversial version of this rational for reserve accumulation in Asia.

An adjustment process that involves a large and sustained increase in the euro's share in Asian reserves would enhance the euro's status as an international reserve currency. How are the prospects of such a development viewed in Europe? On the one hand, Europe can earn seignorage revenue and increased capital inflows should boost asset prices and lower long–term European interest rates. On the other hand, reserve currency status may result in higher volatility of the euro, which in the past the Bundesbank has been reluctant to accept.

6. Conclusions

In today's highly integrated world economy, every region is likely to be affected by the inevitable unwinding of global current account imbalances. As discussed in Ahearne and von Hagen (2005), Europe should prepare for global current account adjustment by adopting a policy of risk management. The domestic macroeconomic consequences of adjustment will be less severe if policies aimed at creating more flexible markets are introduced, especially in the services sector. Fiscal policy can cushion some of the shock to aggregate demand that will accompany adjustment. To facilitate this, European governments should now be striving to improve fiscal positions. Finally, the ECB should make it clear that it would respond to deflationary pressures by easing monetary policy significantly, thus avoiding the risk of deflationary expectations that might raise the cost of adjustment even further.

The policies above should help to position Europe to better withstand the effects of global adjustment. Ultimately, of course, the burden of adjustment that Europe will have to bear will depend on decisions made in foreign countries, especially in Asia.

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Table 1. Current Account Balances ($bn)

	1995	2002	2005
United States	-114	-472	-791
UK	-14	-25	-58
Euro area	44	54	-35
Asia	72	240	405
Japan	111	113	164
China	2	35	159
Korea	-9	5	17
Major Oil Exporters*	11	91	374

*Includes Iran, Qatar, Indonesia, Saudi Arabia, Kuwait, Libya, UAE, Nigeria, Venezuela, Norway and Russia
Source: BEA, IMF and OECD

Table 2. 2005 Bilateral Trade Balance ($bn)**

	EU15	China	Japan	Major Oil Exporters
United States	-96	-202	-83	-109
EU15		-128	-45	-135
China**			-6	-3
Japan				-84
Major Oil Exporters				

*A negative figure means that the region in the left-hand column ran a deficit with the region in the row.
**includes Hong Kong
Source: IMF

Table 3. Composition of US capital flows (1999-2005) ($bn)

	1999	2000	2001	2002	2003	2004	2005
Current Account Balance	**-299.8**	**-415.2**	**-389.0**	**-472.4**	**-527.5**	**-665.3**	**-791.5**
Capital Account Balance	**-4.9**	**-1.0**	**-1.3**	**-1.5**	**-3.3**	**-2.3**	**-4.4**
Financial Account Balance	**257.6**	**454.5**	**342.7**	**457.3**	**460.7**	**609.2**	**799.6**
Official capital, net	**55.0**	**41.5**	**22.7**	**112.6**	**280.3**	**392.3**	**219.1**
Foreign official assets in the U.S.	43.5	42.8	28.1	115.9	278.3	387.8	199.5
U.S. official reserve assets	8.7	-0.3	-4.9	-3.7	1.5	2.8	14.1
Other U.S. government assets	2.8	-0.9	-0.5	0.3	0.5	1.7	5.5
Private capital, net	**202.6**	**413.0**	**320.0**	**344.7**	**180.3**	**216.9**	**580.4**
Net banking inflows	**-16.5**	**-16.4**	**-17.3**	**58.2**	**84.2**	**-24.9**	**-33.2**
Securities transactions, net	**132.1**	**262.0**	**288.9**	**335.1**	**165.4**	**337.9**	**493.5**
Foreign net purchases (+) of U.S. securities	254.3	389.9	379.5	383.7	312.2	484.4	673.6
Treasury securities	-44.5	-70.0	-14.4	100.4	91.5	102.9	199.5
Agency bonds	43.1	101.0	82.8	81.8	-36.8	67.4	72.4
Corporate and other bonds	142.8	166.4	191.6	145.4	223.2	254.6	316.0
Corporate stocks	112.9	192.5	119.5	56.1	34.3	59.5	85.8
U.S. net purchases (-) of foreign securities	-122.2	-127.9	-90.6	-48.6	-146.7	-146.5	-180.1
Bonds	-7.9	-21.2	18.5	-31.6	-28.7	-61.8	-38.0
Stocks	-114.3	-106.7	-109.1	-17.0	-118.0	-84.8	-142.1
Direct investment, net	**64.5**	**162.1**	**24.7**	**-70.1**	**-85.9**	**-111.0**	**100.7**
Foreign direct investment in the U.S.	289.4	321.3	167.0	84.4	64.0	133.2	109.8
U.S. direct investment abroad	-224.9	-159.2	-142.3	-154.5	-149.9	-244.1	-9.1
Foreign holdings of U.S. currency	**22.4**	**5.3**	**23.8**	**21.5**	**16.6**	**14.8**	**19.4**
Statistical discrepancy	**68.6**	**-70.2**	**-10.0**	**-29.3**	**-7.5**	**85.1**	**10.4**

Source: BEA

Table 4. Foreign purchases of U.S. Treasury securities (1999-2005) ($bn)

	1999	2000	2001	2002	2003	2004	2005
U.S. Treasury bonds and notes, excl. transactions of foreign official agencies	**-24.7**	**-65.3**	**-23.2**	**78.4**	**91.0**	**83.4**	**215.4**
Net purchases by foreigners, by area:							
Europe	-41.0	-54.9	-30.2	38.7	18.1	38.2	68.4
Canada	7.8	2.1	0.2	-5.0	11.4	16.3	21.8
Caribbean financial centers	-12.8	-5.1	1.0	14.8	6.2	22.1	64.2
Latin America, excl. CAR financial centers	2.6	-1.2	-3.3	3.1	3.0	-3.4	10.5
Asia	17.8	-7.2	8.1	22.3	46.4	10.4	46.1
Africa	-0.4	-0.1	0.1	1.1	-0.2	0.7	2.0
Other	1.3	1.1	1.0	3.6	6.1	-0.8	2.5

Source: BEA

Table 5. Composition of US capital flows with EU (1999-2005) ($bn)

	1999	2000	2001	2002	2003	2004	2005
U.S.-owned assets abroad, net (increase/financial outflow (-))	**-273.1**	**-312.2**	**-196.0**	**-131.2**	**-223.5**	**-432.6**	**-137.2**
U.S. private assets, net	-271.1	-311.5	-195.7	-131.1	-223.7	-432.7	-137.9
Of which:							
U.S. direct investment abroad	-97.8	-70.6	-57.8	-70.0	-70.5	-86.5	28.6
U.S. purchase of EU securities	-54.4	-88.8	-51.5	-33.3	-57.0	-118.5	-68.6
EU-owned assets in the U.S. net (increase/financial inflow (+))	**408.8**	**593.0**	**361.9**	**214.6**	**244.5**	**461.0**	**455.1**
Of which:							
EU direct investment in U.S.	220.3	236.7	60.0	34.4	30.4	58.3	65.0
EU purchases of U.S. Treasuries	-41.0	-54.9	-30.2	38.7	18.1	38.2	68.4
EU purchases of non-U.S. Treasuries	188.4	314.1	212.7	102.7	106.5	153.8	219.6
Statistical discrepancy	**-95.6**	**-226.8**	**-112.7**	**-4.1**	**68.0**	**78.9**	**-175.9**
Balance on current account	**-39.8**	**-53.8**	**-53.0**	**-79.0**	**-88.7**	**-107.0**	**-141.5**

Source: BEA

Table 6. European purchases of U.S. securities other than U.S. Treasury securities ($bn)

	1999	2000	2001	2002	2003	2004	2005
Stocks, net purchases							
Europe	92.0	181.6	86.8	31.5	22.1	35.3	43.2
Of which: United Kingdom	40.6	71.8	37.3	14.4	0.2	28.9	23.6
Corporate bonds, net purchases							
Europe	96.1	111.7	108.4	78.9	130.9	126.3	200.9
Of which: United Kingdom	77.1	95.2	84.1	55.8	89.0	69.6	140.2
Agency bonds							
Europe	9.4	36.8	29.6	4.7	-29.4	13.3	-11.9
Of which: United Kingdom	5.0	28.5	33.4	22.4	14.6	31.4	-3.8

Source: BEA

Table 7. U.S. Investment: Net Income and Stocks vis-a-vis EU* ($bn)

	1999	2000	2001	2002	2003	2004	2005
A. Net Income	**-13.4**	**-8.6**	**-3.1**	**-7.4**	**-0.8**	**-7.8**	**-25.5**
Of which:							
Direct investment net	15.9	21.0	32.2	32.4	27.9	24.8	13.3
Receipts							
Income receipts	**111.2**	**134.3**	**111.0**	**104.5**	**118.5**	**142.9**	**182.3**
Of which:							
Direct investment receipts	50.4	57.9	44.7	51.5	70.1	81.5	89.5
Payments							
Income payments	**-124.5**	**-142.9**	**-114.2**	**-111.8**	**-119.3**	**-150.7**	**-207.8**
Of which:							
Direct investment payments	-34.5	-36.8	-12.5	-19.1	-42.1	-56.7	-76.2
B. Net Stocks	---	---	---	---.	**-18.0**	**-289.1**	**n.a.**
Portfolio holdings, net**	---	---	---	---.	**-108.6**	**-315.1**	**n.a.**
US holdings of EU securities	n.a.	n.a.	1186.9	n.a.	1542.0	1790.4	n.a.
EU holdings of US securities	n.a.	1351.0	n.a.	1430.7	1650.5	2105.5	n.a.
Direct Investment, net***	**-21.4**	**-163.8**	**-105.1**	**0.6**	**90.5**	**26.0**	**n.a.**
US Direct Investment in EU	676.8	731.6	821.0	909.8	1035.1	1061.8	n.a.
EU Direct Investment in U.S.	698.3	895.4	926.1	909.2	944.6	1035.8	n.a.

*EU15 up to 2004, EU25 in 2004 and 2005
** market value
*** current cost
Source: BEA, TIC and own estimates

Table 8. Foreign holdings of dollar assets ($bn)

	2000	2002	2004
Euro area	1,845	2,237	2,961
Asia*	1,219	1,567	2,421
Japan	750	940	1,373
China	172	270	434
Major Oil Exporters*	105	165	267

*Norway, Venezuela, Algeria, Gabon, Nigeria, Kuwait, Saudi Arabia, UAE, Bahrain, Iran, Iraq, Qatar, Russia

Source: BEA and US Treasury

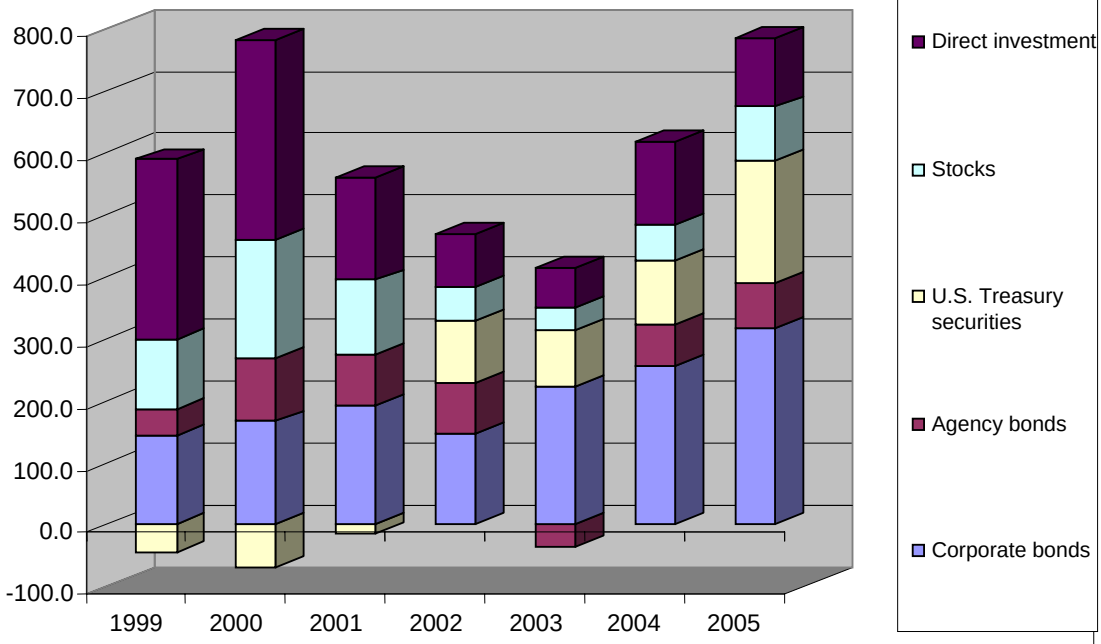
Table 9. Euro area trade with China and US, 1998 and 2005 (per cent of GDP)

	Exports to				Imports from			
	China		US		China		US	
	1998	2005	1998	2005	1998	2005	1998	2005
Austria	0.3	0.8	1.2	2.4	0.4	0.9	1.1	0.9
Belgium	0.7	1.4	3.5	5.4	1.1	3.6	4.9	4.4
Germany	0.5	1.1	2.3	3.1	0.6	1.6	1.4	1.4
Spain	0.2	0.2	0.8	0.7	0.5	1.1	1.1	0.7
Finland	1.4	1.2	2.5	2.1	0.5	1.3	1.6	1.1
France	0.5	0.5	1.7	1.6	0.4	0.9	1.6	1.2
Greece	0.1	0.1	0.4	0.4	0.5	1.0	1.1	0.8
Ireland	0.5	1.0	9.7	10.3	0.8	1.1	7.9	4.7
Italy	0.4	0.5	1.7	1.7	0.4	1.0	0.9	0.8
Netherlands	0.4	0.7	2.0	2.8	1.9	5.6	4.7	4.5
Portugal	0.1	0.2	1.0	1.1	0.3	0.4	0.9	0.7

Source: Eurostat

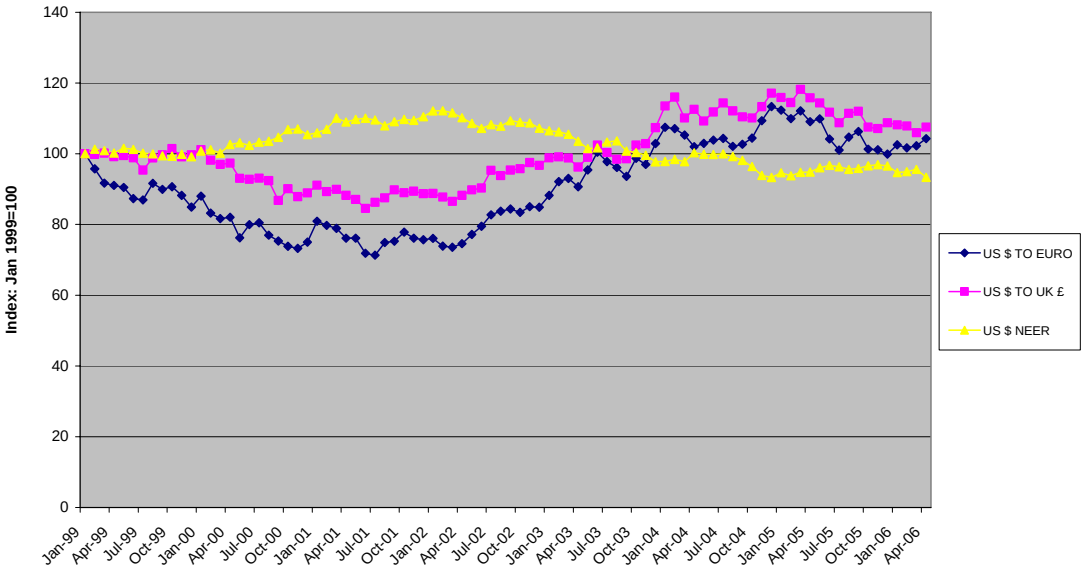
Figure 1:

Private US capital inflows (bn$)



Source: BEA

Figure 2:
US $ Exchange Rates



Source: Datastream and Federal Reserve

Figure 3:
Current Accounts

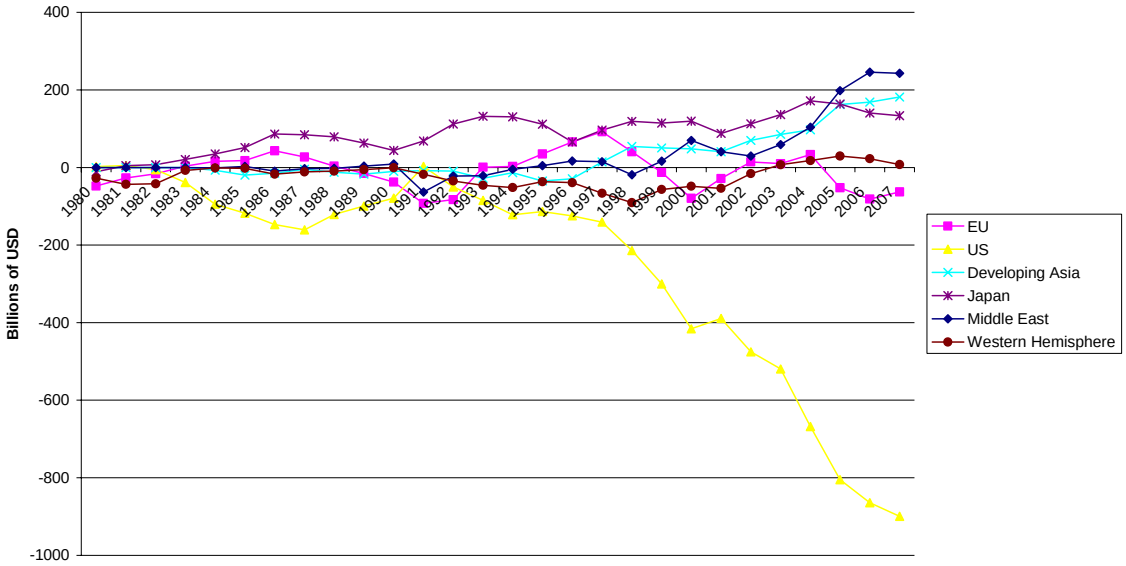


Figure 4:
Cumulated Current Accounts

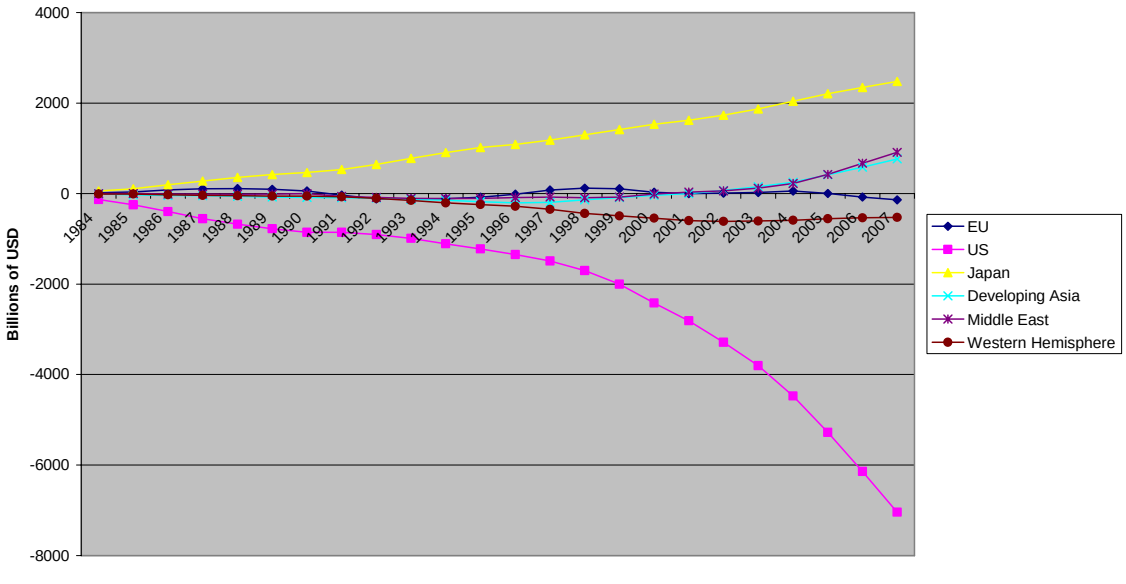


Figure 5:
Cumulated Current Accounts