

U.S. IMBALANCES AND THE EURO'S OUTLOOK

Kenneth Rogoff

It is difficult to discuss the euro in purely economic terms because the euro is fundamentally a political issue. Many things go on in the name of the euro. If you ask Europeans about the euro, they will raise issues ranging from European integration to democracy to education to the weather in Provence. Many positive steps have been taken in the name of euro. For example, the Stability and Growth Pact, for all its flaws, has been wonderful for the smaller countries. But at the same time, the SGP has little connection with being in a currency union. The direct economic effects of currency union are often overstated. Indeed, there is much debate and it is not at all obvious that currency union is a net positive in narrow economic terms.

Perhaps the single most important direct economic effect of the euro has been to create deeper financial markets in Europe. Unfortunately, the benefits from those markets may be a long time coming if takeovers and mergers remain difficult, and labor markets continue to be rigid. In the United States, financial deepening has allowed money to suddenly shift from one part of the economy to another, often to the dismay of managers who are seeing their companies being taken over. And the system works also because labor markets are reasonably flexible. Without the ability to displace workers, industry consolidation would be difficult, and the benefits of financial integration would be much less. Deepening European financial markets is important, but it is only a first step.

The Short-Term Challenge

The biggest short-term test for the euro will be what happens to the global monetary order when the U.S. current account is brought into

Cato Journal, Vol. 24, Nos. 1–2 (Spring/Summer 2004). Copyright © Cato Institute. All rights reserved.

Kenneth Rogoff is Professor of Economics at Harvard University and former Chief Economist at the International Monetary Fund.

balance. I agree with Fed Chairman Alan Greenspan (2004) that as the global economy becomes more flexible, the adjustment process becomes less burdensome. But how flexible is the global economy? Europe certainly isn't. Japan isn't. Latin America isn't. Also, it is quite wrong to think that just because capital markets are deep, commodity markets can seamlessly adjust to a giant shift in global demand toward the United States and away from the rest of the world—which is exactly what a closing-up of the U.S. current account deficit must imply. Hence, I believe that it is very likely that when the U.S. current account reverses, there will be a sharp drop in the dollar and an adverse effect on global output. Maurice Obstfeld and I presented a model of this phenomenon three years ago at the annual Federal Reserve Bank of Kansas City symposium in Jackson Hole (Obstfeld and Rogoff 2000). At the time, our view was contrarian, now it is conventional, and I still believe it is right. I might note that our model was calibrated to present-day international capital and goods market integration, so I am not convinced by the argument that the increased integration has made the problem much more manageable. The fact is that the U.S. current account is more than 5 percent of national income and, more important, corresponds to roughly 25 percent of traded goods consumption. That is why our model—and now many others—suggests that a sharp reversal of the U.S. current account deficit will necessitate such a sharp drop in the exchange rate.

How can I say that the dollar is overvalued when my own work at the Federal Reserve 20 years ago says you cannot say anything about it? I think we are at a peculiar moment in history where central banks, especially in Asia, are not really return oriented in their demand for dollars. In such a situation it is possible for people in the market to make money off of those central banks, as many studies have shown. The dollar seems very overvalued on the basis of purchasing power parity, and it is overvalued looking at the U.S. current account.

What is going to happen to the euro? We could see a euro at \$1.50 with no problem if the U.S. current account even closed up a few percentage points. That outcome would not be catastrophic, but it certainly would be awfully painful in Europe. Of course, it would be less painful if the Asian central banks permitted their currencies to appreciate, but it is not obvious how that is going to play out. Indeed, that is the big question in the global monetary order.

The Need for Flexibility

The global economy is “flying on one engine” (Beddoes 2003) and that is bad enough, but it will be even worse if it has to land on one

wheel, which is the euro. Ultimately, the United States needs to save more, but how are we going to deal with the short-term adjustment problems? More flexibility would help, but I doubt that we are going to see more flexibility in the very near future.

I certainly think one of the wrong lessons some have learned from the Asian crisis is that somehow countries should deal with volatile financial markets by putting in more capital controls or trade restrictions. Such restrictions will make the adjustment process to current account reversals more traumatic not less. Indeed, if you try to bottle-up the adjustment process with capital controls and trade restrictions, you are simply buying time to have a bigger crisis later on. Ultimately, countries need more flexibility, and to the extent policy can do something about it, that is where the focus should be.

References

- Beddoes, Z. M. (2003) "Flying on One Engine." A Survey of the World Economy. *The Economist* (September 20).
- Greenspan, A. (2004) "The Evolving U.S. Payments Imbalance and Its Impact on Europe and the Rest of the World." *Cato Journal* 24 (Spring/Summer): 1–11.
- Obstfeld, M., and Rogoff, K. (2001) "Perspectives on OECD Capital Market Integration: Implications for U.S. Current Account Adjustment." In Federal Reserve Bank of Kansas City *Global Economic Integration: Opportunities and Challenges*, 169–208.