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Op-Ed Contributor

How to Fix the Global Economy

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THE International Monetary Fund meeting in Singapore last month came at a time of increasing worry about the sustainability of global financial imbalances: For how long can the global economy endure America�s enormous trade deficits � the United States borrows close to $3 billion a day � or China�s growing trade surplus of almost $500 million a day?

These imbalances simply can�t go on forever. The good news is that there is a growing consensus to this effect. The bad news is that no country believes its policies are to blame. The United States points its finger at China�s undervalued currency, while the rest of the world singles out the huge American fiscal and trade deficits.

To its credit, the International Monetary Fund has started to focus on this issue after 15 years of preoccupation with development and transition. Regrettably, however, the fund�s approach has been to monitor every country�s economic policies, a strategy that risks addressing symptoms without confronting the larger systemic problem.

Treating the symptoms could actually make matters worse, at least in the short run. Take, for instance, the question of China�s undervalued exchange rate and the country�s resulting surplus, which the United States Treasury suggests is at the core of the problem. Even if China strengthened its yuan relative to the dollar and eliminated its $114 billion a year trade surplus with the United States, and even if that immediately translated into a reduction in the American multilateral trade deficit, the United States would still be borrowing more than $2 billion a day: an improvement, but hardly a solution.

Of course, it is even more likely that there would be no significant change in America�s multilateral trade deficit at all. The United States would simply buy fewer textiles from China and more from Bangladesh, Cambodia and other developing countries.

Meanwhile, because a stronger yuan would make imported American food cheaper in China, the poorest Chinese � the farmers � would see their incomes fall as domestic prices for agriculture dipped. China might choose to counter the depressing effect of America�s huge agricultural subsidies by diverting money badly needed for industrial development into subsidies for its farmers. China�s growth might accordingly be slowed, which would slow growth globally.

As it is, however, China knows well the terms of its hidden �deal� with the United States: China helps finance the American deficits by buying treasury bonds with the money it gets from its exports. If it doesn�t, the dollar will weaken further, which will lower the value of China�s dollar reserves (by the end of the year, these will exceed $1 trillion). Any country that might benefit from China�s loss of export market share would put its money into a strong currency, like the euro, rather than the unstable and weakening dollar � or it might choose to invest the money at home, rather than holding more reserves. In short, the United States would find it increasingly difficult to finance its deficits, and the world as a whole might face greater, not less, instability.

Nothing significant can be done about these global imbalances unless the United States attacks its own problems. No one seriously proposes that businesses save money instead of investing in expanding production simply to correct the problem of the trade deficit; and while there may be sermons aplenty about why Americans should save more � certainly more than the negative amount households saved last year � no one in either political party has devised a fail-proof way of ensuring that they do so. The Bush tax cuts didn�t do it. Expanded incentives for saving didn�t do it.

Indeed, most calculations show that these actually reduce national savings, since the cost to the government in lost revenue is greater than the increased household savings. The common wisdom is that there is but one alternative: reducing the government�s deficit.

Imagine that the Bush administration suddenly got religion (at least, the religion of fiscal responsibility) and cut expenditures. Assume that raising taxes is unlikely for an administration that has been arguing for further tax cuts. The expenditure cuts by themselves would lead to a weakening of the American and global economy. The Federal Reserve might try to offset this by lowering interest rates, and this might protect the American economy � by encouraging debt-ridden American households to try to take even more money out of their home-equity loans to pay for spending. But that would make America�s future even more precarious.

There is one way out of this seeming impasse: expenditure cuts combined with an increase in taxes on upper-income Americans and a reduction in taxes on lower-income Americans. The expenditure cuts would, of course, by themselves reduce spending, but because poor individuals consume a larger fraction of their income than the rich, the �switch� in taxes would, by itself, increase spending. If appropriately designed, such a combination could simultaneously sustain the American economy and reduce the deficit.

Not surprisingly, these recommendations did not emerge from the International Monetary Fund meetings in Singapore. The United States retains a veto there, making it unlikely that the fund will recommend policies that aren�t to the liking of the American administration.

Underlying the current imbalances are fundamental structural problems with the global reserve system. John Maynard Keynes called attention to these problems three-quarters of a century ago. His ideas on how to reform the global monetary system, including creating a new reserve system based on a new international currency, can, with a little work, be adapted to today�s economy. Until we attack the structural problems, the world is likely to continue to be plagued by imbalances that threaten the financial stability and economic well-being of us all.

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