The United States current account deficit (CAD) was $791 billion in 2005, an 18.9 percent increase relative to $665 billion a year earlier.\(^1\) The trade deficit was $717 billion in 2005, an increase of 17.3 percent compared with $611 billion a year earlier. Using the estimate of nominal GDP of $12,293 billion by the Congressional Budget Office (CBO), the CAD would amount to 6.4 percent of GDP and the trade deficit to 5.8 percent.\(^2\) In mid-2005, trade with China was 30 percent of the US trade deficit and the deficit with the entire Pacific Rim about 50 percent. The North American Free Trade Agreement (NAFTA) members had a share of 17 percent.\(^3\) The current account deficit of the US absorbs more than three quarters of the world surpluses. There is valid concern as to how long the US can continue to absorb these huge amounts of foreign financing and how the world economy would react to an exit out of dollar positions. The latest available data for 2005 show the net international investment position (NIIP) of the US at $2546 billion, or 20.7 percent of GDP of $12,293 billion, equal to external assets of $11,079 billion, or 90.1 percent of GDP, less external liabilities of $13,625 billion, or 108.3 percent of GDP. These data and events generate unusual interest in the financial press and in the policy literature.

The former Vice Chairman of the Board of Governors of the FRB observed that (Ferguson (2005, 1)): “Not since joining the Federal Reserve Board have I seen this topic show up in the financial press as frequently—and so often with such ominous overtones—as it does these days.” Two distinguished academics describe the nature of the debate (Obstfeld and Rogoff (2005b, 52)): “Nonetheless, in a literature that is often long on polemics and short on analysis, we hope it is useful to have advanced a concrete model on which to base policy analysis.”
The objective of this volume is to impartially probe the vast findings of this theoretical and policy effort to provide clear thought on the risks of global trade and fiscal deficits for output, employment and stability. The United States needs effective policies toward its trade and fiscal imbalances, in particular, its growing CAD and NIIP. Distinguished economists and policy makers have advanced the concern that an abrupt adjustment of the US could cause a global recession. Various chapters below discuss in turn the current account of the United States, the risks it poses to the internal and world economies, the active policy debate, the economy and external relations of China, Japan, the euro area and the US and a synthesis of sound policy. A chapter relates the findings to currency crashes as important illustrations of how other emerging countries in the world face difficult policies and political choices. The conclusion summarizes the major findings.

Cooper (2004) borrows a famous term of John Kenneth Galbraith, conventional wisdom, to label an influential and intellectually elegant proposal to adjust the external imbalance of the United States. The policies of this conventional approach consist of slow depreciation of the dollar, revaluation of East Asian currencies, decrease in demand relative to income in the United States and increase in demand relative to income in Europe and Japan. The Plaza Accord (1985) was one such coordinated effort by the G5 wealthiest countries in the world—the United States, Japan, Germany, France and the United Kingdom. Even such small group of nations bound by some common interests could not agree on the required change of interest rate differentials of the complementary Louvre Agreement. The new policy proposal would require coordinated action by most countries in the world on some of the most sensitive issues of sovereignty, such as domestic employment and exchange rate policy. It also requires economic knowledge and policy instruments that currently are inadequate to implement the proposal.

The conventional approach on global imbalances has become official international financial doctrine. This approach is the main policy theme in this volume. The finance ministries and central banks of the Group of Seven (2006) affirmed in their Washington meeting the principle that global economic adjustment is a “shared responsibility.” The meeting stated that greater flexibility of exchange rates would moderate trade surpluses in countries such as China in a shared effort to reduce global imbalances. The ministers and governors supported stronger surveillance by the IMF to maintain consistency between exchange rate and domestic policies.