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# ECONOMIC VIEWPOINT

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## In the End, It All Comes Down to Supply and Demand

Despite the complexities of the current spate of debates on euro support, trade imbalances, capital import controls and currency values, each of these issues can be traced back to imbalances between supply and demand and some failure of price adjustment. Whenever governments try to deal with the symptoms rather than the underlying causes of these imbalances, they end up wasting resources because at root bottom not enough has fundamentally changed.

In the case of Europe, struggling to deal with imbalances between its richer, surplus economies and the poorer, debtor members of the Union, the issue, as Martin Wolf has repeatedly pointed out, is that the main channel of adjustment, namely the exchange rate, is off the table. Hence the great difficulty for the highly indebted countries, such as Greece, Spain, Portugal, Ireland and Italy, to adjust their fiscal imbalances. There simply is too little demand in Germany and other EU surplus countries and too much in others. Without an exchange rate adjustment, the deflationary pressures will continue and the cost of maintaining the value of deficit member bonds will be borne by surplus members.

Looking at persistent trade imbalances between the U.S. and China, one may see the problem as an exchange rate misalignment or rather as a shortage of demand from China for American products and an excessive appetite for Chinese imports on the part of the U.S. This imbalance could be resolved in theory by a radical shift in prices; however, neither country really wants that to happen. The Chinese motives to maintain employment and growth are well known. The ability of the U.S. to use its reserve currency status to avoid a dramatic price change is also clear. So if price adjustments alone cannot redress imbalances, what can?

Much has been written about the need to allow China more time to open its capital account and allow free convertibility of the currency. That was the line when reserves stood at one trillion dollars and it is still espoused as reserves hit three trillion dollars. What China needs to do is to go on a massive spending spree in the U.S. This would serve to reduce trade imbalances; it would restore confidence and boost U.S aggregate demand; it would reduce the incentives for the Fed to continue its quantitative easing that is driving interest rates down without apparent impact on the real economy and sending capital fleeing to emerging market economies; and it would preserve more value in those three trillion dollars of Chinese reserves. If price cannot be adjusted sufficiently, directly attacking the supply and demand for goods and services might help.

And what about the excessive demand for Brazilian stocks and bonds that has prompted Finance Minister Mantega to declare war on the currency wars? Unfortunately, neither a 2 percent, nor a 4 percent, nor a 6 percent capital import tax will deter capital from seeking higher returns in Brazil, when interest rates are low and the outlook in advanced economies is bleak. There is, of course, a strong argument to try and discourage short-term, highly volatile capital inflows; however, the mechanics of an appreciating Reis drawing in capital that is then sterilized and hence raising rates further is unlikely to be reversed without some dramatic changes in supply and demand for global capital.

At the end of the day, the new normal equilibrium will involve greater spending by the surplus countries and greater supply of goods by the deficit countries. As long as accumulators over-save, their currencies will be overvalued. And in the case of fixed currency areas like the EU, transfers will be required to offset the lack of adjustment. The longer it takes to get to this equilibrium in supply and demand, the more we will hear of currency wars, the Fed's flooding the market with dollars, and euro-bailouts. ■



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