

Central banks and global imbalances

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1 Introductory remarks

THE DEBATE ON GLOBAL IMBALANCES is due mainly to the large and growing US current account deficit. In 2005 it amounted to an unprecedented USD 805 billion (6½% of US GDP). Estimates by the IMF for this year and next do not indicate marked changes in the US current account position. The United States accounts for around ¾ of the global aggregate current account deficit. Not surprisingly, the corresponding current account surpluses are more broadly spread. Among the major surplus regions, Asian economies like Japan and China and oil-exporting countries play the most important roles. By contrast, the euro-area's current account position is roughly balanced, although significant heterogeneities can be detected at the national level.

The current account positions of developed and emerging economies underwent marked shifts during the past few years. In 1998, the developed economies still had an aggregate current account surplus of USD 24 billion. In 2005, however, a current account deficit of USD 475 billion had emerged – predominantly caused by a worsening US balance. In 1998, the emerging economies and developing countries still had an aggregate deficit of USD 116 billion; in 2005, they had a surplus of USD 406 billion. Moreover, accumulation of currency reserves in emerging economies remains at a high level despite some slowdown in 2005. Total official currency reserves have more than tripled in the past ten years and almost doubled in the past four years.

2 The debate on sustainability

Given the global distribution of current account balances, developments at the global level are important, but developments in the US are key for judging the ultimate

sustainability of the current configuration. This is consistent with the G7 statement we issued at the Washington meeting in April. So, let's "Google Earth" the US economy.

The current account deficit in the US mirrors the low level of national saving. Net saving fell to a low-point of less than 1% of gross national income; a figure not reached since the Great Depression in the 1930s. By contrast, in 1998 the private saving rate was still as high as 6.5%. Household and public saving are both contributing to this development. In net terms, households' personal savings were negative in 2005 for the first time since the 1930s. Net government savings fell from a surplus of USD 240 billion in 2000 to a deficit of USD 323 billion in 2005. National savings have been supported by a steep increase in corporate savings owing to undistributed profits.

The large overall gap between national saving and investment of more than 6% of GDP corresponds, by definition, to the ballooning US current account deficit.

"Google Earthing" the global economy tells us that, up to now, funds have happily been supplied by the rest of the world. Will this continue? Or is it unsustainable? I tend towards the second camp. This immediately leads to the next question: If the US current account deficit unwinds, will it happen in an orderly or disorderly fashion?

2.1 Intertemporal considerations

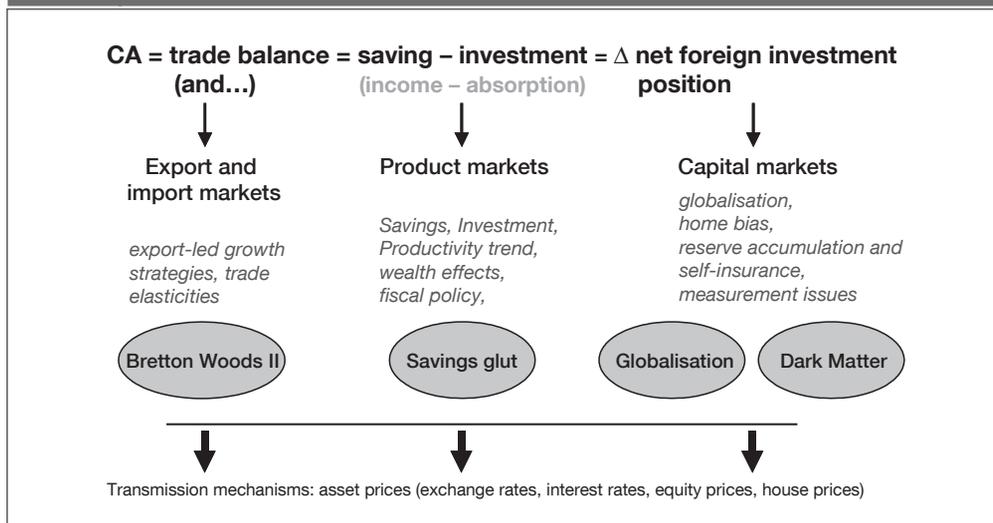
A fruitful discussion of sustainability needs to be formulated in terms of intertemporal considerations. Simple intertemporal mechanics suggest that the trajectory of US current account dynamics is not sustainable. A net external debtor cannot carry on accumulating trade deficits indefinitely in any intertemporal model. Continuation of current trends would likewise lead to a further massive increase in the USA's net debtor position. As an example, a 6.5% current account deficit and 5% nominal GDP growth leads to a negative net external position of 130% of US GDP, neglecting valuation effects. It would also imply an ever larger part of the US capital stock being in foreign ownership. This may also raise questions about political acceptance.

Given this background, it is justified to assume that adjustment will come, as what cannot go on forever will not go on forever and will eventually have to stop. The only question is "when and how?". At this point, the relevance of differing positions becomes apparent and explanations of the causes of the US current account deficit become important. Moreover, these explanations are crucial for possible policy measures as the remedy applied depends on the particular ailment.

2.2 Explanations for the longer-term persistence of the current imbalances

Several theories postulate that the accumulation of foreign debt by the US can go on for longer than commonly assumed. The explanations can be grouped under the following headings:

SCHEMA 1 PERSPECTIVES ON THE CURRENT ACCOUNT



- Globalisation
- Strength of the US economy
- Bretton Woods II
- Dark matter

These explanations each emphasise a different aspect of the fundamental determinants of the current account. They can be pedagogically separated into at least three fields, which are, of course, highly interdependent and not mutually exclusive since the current account is an endogenous variable which mirrors developments on nearly all relevant markets. These fields are the trade view, product market view and capital market view.

The core of the *globalisation argument* is as follows: integrated global financial markets reduce home bias and allow financing of higher current account deficits than hitherto. This is undoubtedly correct in part, but not an argument for the sustainability of the current configuration. Moreover, owing to possibility of herding, integrated capital markets may also complicate necessary processes of adjustment.

Proponents emphasising the inherent *strength of the US economy* argue that the attractiveness of US capital markets for global savings – due to high returns on capital owing to high productivity growth of the US economy – will continue to allow financing of deficits on the present scale. There is some truth in this argument, too, but it, likewise, is no argument against the simple intertemporal arithmetic. For example, even if US productivity growth were to permit nominal growth of 7%, the US net external debt position would show a massive increase before reaching a new steady state (over 90% of GDP in this case, compared to

130% were nominal growth only 5% on average, again neglecting valuation effects).

The *Bretton Woods II argument* postulates that the growing US savings gap can be financed without difficulty as long as the Asian (or other) central banks are willing to accumulate reserve assets denominated in US dollars. They will have an incentive to do so as part of an export-based and exchange rate-driven growth strategy. In my view, drawing a parallel between BW I and BW II, however, overlooks some relevant facts. Firstly, in the original Bretton Woods agreement, the United States was posting current account surpluses. Secondly, there are inherent high risks and costs of reserves accumulation that should be taken into account. Sterilisation gives rise to costs if interest rates at home are higher than abroad, non-sterilisation implies liquidity risks and threat of inflation. Moreover, the accumulation of reserves is linked to high valuation risks in the event of depreciation. This may constitute a first mover problem, although, it has to be said that asset management considerations are not the primary motivation for central banks' reserve holdings.

There is one last difference between BW I and BW II: in the euro, the current global financial system has a potential alternative reserve currency.

Last but not least, the *dark matter hypothesis* states that the US net asset position is not being captured accurately in the statistics and that, if these supposedly unrecorded assets – called “dark matter” – are taken into consideration, the current account deficit all but disappears. As their starting point, proponents of the dark matter camp take the somewhat surprising fact that despite a recorded negative US external position of USD 2.5 trillion, US cross-border income flows have been positive, amounting to USD 36 billion in 2004. The favoured explanation is this: US financial assets are recorded inaccurately – the discrepancy vis-à-vis official figures being called dark matter – due to the US enterprises' export of intangible assets, such as brand names and expertise.

One immediate criticism of this explanation is that the a priori assumption – that current account figures and net position are wrong, while the figures on cross-border income are correct – is more than questionable. For example, the possible role of tax-induced profit-shifting by multinational groups can distort cross-border income figures. Moreover, it is probable that the positive sign of the net investment income is due to differentials in the average returns between US investments abroad and foreign investment in the USA as the IMF pointed out some time ago. This has been recently confirmed empirically by research of Lane and Milesi-Ferretti. Reasons for this can be found in structural differences between the portfolio of US assets abroad and US liabilities – with more equity instruments on the asset side and more debt instruments on the liability side – and valuation effects due to exchange rate movements and asset price developments. Finally, US cross-border income is highly volatile; last year, it amounted to no more than USD 1.6 billion making dark matter itself an extremely volatile concept.

Summing up, in the final analysis, none of the theories put forward makes a convincing argument against the contention that there is a lack of sustainability in current global imbalances.

2.3 Empirical findings on effects of current account adjustments

Going back to my key hypothesis that what cannot go on forever will not go on forever leaves one point unanswered: will the unwinding of the current unsustainable configuration be abrupt and disorderly and, if it is, what will the macroeconomic consequences be?"

Empirical studies of historical cases of sharp declines in current account deficits do not provide us with clear cut answers. For example, while Croke, Kamin and Leduc, in a study by the Federal Reserve, discovered little evidence that past sharp current account adjustments in industrial countries resulted in cumulated economic stress, Sebastian Edwards found that sharp falls in the current account deficit do indeed tend to have a negative impact on growth. An inherent problem in studies of this kind, however, is that there is no historical precedent for the current situation with large and increasing deficits over a long period in the world's most important economy.

3 What role can policy play?

In view of the risks, the existing uncertainties about the when and how of eventual adjustment are by no means justification for inaction. Especially in the current favourable international setting, prudent policy demands a gradual implementation of adjustment mechanisms. This will be primarily a market process. However, policy can play a supporting role.

The unwinding of global imbalances is a joint task, as was also emphasised in the G7 statement in April 2006. This is all the more appropriate as empirical studies show that an adjustment through isolated channels is not very likely and would call for dramatic changes in the relevant variables and prices that are neither realistic nor desirable. Thus, the familiar three-pronged approach we reiterated at the G7 meeting in Washington remains valid.

Adjustment measures in the US aiming to increase national savings are key. In that respect, despite a somewhat loose general relationship between fiscal deficits and the current account in empirical studies, budgetary consolidation in the US remains of paramount importance. According to a Fed study, a 1 pp reduction in the government deficit would lower the current account deficit by up to 0.2 pp. According to an IMF study, it would actually be reduced by as much as 0.5 pp. If the IMF is right, medium-term balancing of the budget would therefore reduce

the current account deficit by 2 pp. Furthermore, households' savings in the US should perhaps be encouraged, although steering the private savings rate through political measures might prove difficult. Promoting energy saving could also play a part in bringing down the deficit considering that 2 pp of the US trade deficit alone (-1/3) is due to net imports of oil.

The Asian emerging economies and China, in particular, should likewise be aware of their responsibility in the unwinding of the global imbalances. Greater exchange rate flexibility will be needed as allowing appreciations would somewhat redirect growth strategy away from export orientation towards domestic demand. The recent Yuan revaluations are a welcome first step in the right direction.

There is an increasingly pressing need for a contribution by oil exporters. Oil-exporting countries should think to increase domestic absorption by strengthening investment in their countries.

For Japan and Europe (especially Germany), there are mainly structural reforms on the agenda. The central focus should be on enhancing the long-term growth potential, while short-term measures do not promise lasting success.

3.1 Role of European monetary policy

Generally, although global imbalances call for multilateral solutions, Europe's role is less important than that of USA, oil exporters and Asia/China.

Europe's contribution consists of achieving greater absorption capacity. Crucial in this respect, however, are sustainable measures (structural reforms), not short-term demand policy.

This has immediate consequences for the role of European monetary policy: it should provide the appropriate conditions to foster sustainable growth in the euro area. At the current juncture, that entails safeguarding price stability by anchoring long-term inflation expectations. As a matter of principle, there is no room for subordinating monetary policy to exchange rate objectives. Finally, monetary policy should speak out clearly about the need for structural reforms in the euro area.

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