

GLOBAL IMBALANCES: DO THEY MATTER?

Miranda Xafa

This article reviews the recent literature on global imbalances and discusses the policy implications of the various theories that have been advanced to explain their unprecedented increase. Most of these theories fit the stylized facts, namely, the steady increase in the U.S. current account deficit, the shift to a surplus position of the developing countries, and the low nominal and real interest rates globally. The “low U.S. savings” theory—reflecting the increase in the fiscal deficit and in housing wealth—views the current account deficit as the result of fiscal and monetary policy decisions in the United States that need to be urgently reversed to prevent a crash landing. Other theories however, focusing on developments outside the United States, portfolio balance effects, or previously neglected benign factors, do not yield such a doomsday scenario. It is relevant to note that there is no historical precedent of disorderly exchange rate adjustment in industrial countries that keep inflation under control (Croke, Kamin, and Leduc 2005). Concerns over a disorderly unwinding of global imbalances therefore appear exaggerated. This view, prevalent among market participants and several prominent academics, has not been widely embraced by policymakers.

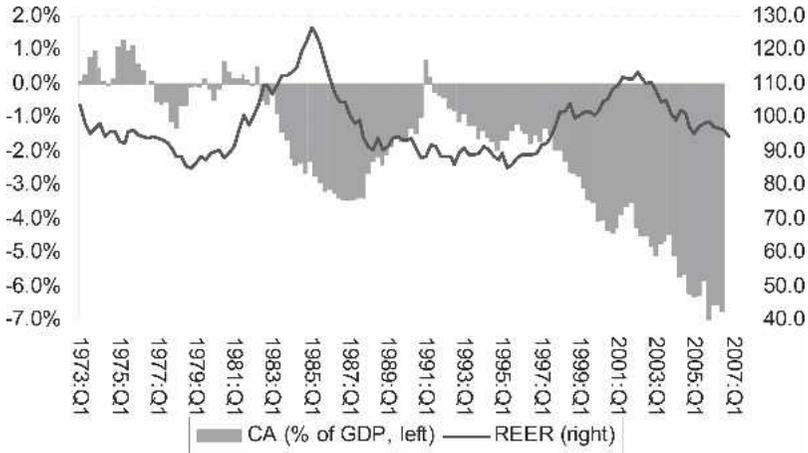
Stylized Facts

The U.S. current account deficit has grown steadily to historically unprecedented levels over the past decade: \$805 billion (6.5 percent of GDP) in 2005 and at an annual rate of \$875 billion (6.7 percent of GDP) in the first three quarters of 2006 (Figure 1). The rising U.S. current account deficit has increased concerns among policymakers about a possible abrupt and disorderly unwinding, involving a major

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Miranda Xafa is a member of the International Monetary Fund’s Executive Board. The views expressed are strictly personal.

FIGURE 1
 U.S. CURRENT ACCOUNT DEFICIT AND THE DOLLAR'S
 REAL EFFECTIVE EXCHANGE RATE (REER)
 (March 1973 = 100)



SOURCES: Federal Reserve and Bureau of Economic Analysis.

sell-off of dollar assets, a sharp increase in U.S. interest rates, and an associated sharp reduction in U.S. absorption. Such an abrupt unwinding of imbalances, triggered by a sudden loss of market confidence in the dollar, would obviously have negative spillover effects on financial markets and the global economy. Policymakers have therefore called for a rebalancing of demand across regions, with the United States reducing its fiscal deficit and the European Union implementing growth-enhancing structural reforms, and for adjustments in exchange rates, with Asian countries letting their currencies appreciate (G-7 Statement, April 21, 2006).

An interesting aspect of the imbalances is that the counterpart of the growing U.S. current account deficit is no longer just Japan and other industrial countries, as was the case a decade ago, but also the developing countries as a group, whose external position shifted from a deficit of \$74 billion in 1996 to a surplus estimated at \$587 billion in 2006 (or from a \$63 billion deficit to \$305 billion surplus if the oil-producing Middle East is excluded). The shift to a surplus position goes against the established wisdom that developing countries should be capital importers.

Finally, U.S. (and global) long-term interest rates, both nominal and real, are well below their historical norms at this stage of the

business cycle, and they have hardly risen following the tightening of U.S. and global liquidity conditions since mid-2004. This fact, known as Greenspan's "conundrum," has helped limit the cost of servicing U.S. external debt.

There is no consensus explanation of the above stylized facts, but several hypotheses have been put forward.

Explaining the Imbalances

The question is whether the widening U.S. current account deficit is due to a temporary aberration or a structural change. A number of competing explanations of the stylized facts have been advanced, all of which conclude that structural changes have made the U.S. deficit and the dollar more sustainable than historical experience would indicate.

The "Low U.S. Savings" View

Obstfeld and Rogoff (2000, 2004), Roubini and Setser (2004), and others focus on the decline in the U.S. national saving rate since the beginning of this decade, reflecting both the swing from fiscal surplus to deficit and falling household savings. They caution that the accumulation of external liabilities by the United States will inevitably result in a sharp fall in the dollar and rise in dollar interest rates. This explanation, however, is not convincing. First, it is inconsistent with the observed low nominal and real interest rates. Second, it cannot explain the fact that the U.S. current account deficit has been rising since 1993, even as the U.S. fiscal deficit was declining sharply until 2001. At a minimum, low U.S. savings cannot be the whole story.

The "Global Savings Glut" View

First advanced by Bernanke (2005), this view emphasizes a combination of factors that have encouraged savings outside of the United States. These include prospective increases in the ratio of retirees to workers in Asia and Europe, a lack of investment opportunities in Asia as it recovers from the 1997–98 crisis, and the rise in oil prices and related rise in the current account surpluses of oil exporters. This global savings glut explains the large U.S. current account deficit, the reversal of capital flows to developing countries, and the low global interest rates. According to this view, we just have to be patient until the factors that attracted global savings to the United States unwind.

The “Revived Bretton Woods” View

Dooley, Folkers-Landau, and Garber (2004, 2005a, 2005b) explain the increase in Asian savings as a consequence of the export-led growth strategy pursued by the authorities. This strategy requires resisting currency appreciation through foreign exchange intervention, so as to keep foreign direct investment (FDI) and investment in tradables profitable. The result is persistent current account surpluses and reserve accumulation by Asian central banks, thus generating Bernanke’s global savings glut and keeping interest rates low.¹ In this view, the accumulation of U.S. Treasury bonds by Asian central banks is effectively used as collateral for FDI. Because of its superior financial sector, the United States intermediates Chinese savings: it imports Chinese savings and reexports a fraction of those savings in the form of FDI. Contrary to conventional wisdom, this development strategy has permitted emerging markets that are net lenders to grow rapidly by ensuring efficient intermediation of their savings. The policy conclusion is the same as Bernanke’s: benign neglect.

Portfolio Balance Models

These models provide an asset market framework to analyze the impact of various shocks on global capital flows and interest rates. In Caballero, Farhi, and Gourinchas (2006), capital flows to the United States either because of its superior growth record relative to the Euro area and Japan, or because of the inability of emerging markets to produce reliable savings instruments with strong property rights in an environment of political stability. Interest rate or exchange rate adjustments can occur only if the growth differential between the United States and Euro area/Japan reverses, or if emerging markets develop their financial systems and start producing high-quality assets. Cooper (2005) presents a similar view in terms of its substantive conclusions. Caballero (2006) also argues that there is a global shortage of financial assets, generated partly by the emerging market crises of the late 1990s and exacerbated by the rapid growth of savings in China and in commodity producing countries that do not generate financial assets on a sufficient scale to satisfy demand. Unlike “sudden stops” in emerging markets, there are no close substitutes to U.S. assets on the scale necessary to trigger a dollar crisis. Blanchard, Giavazzi, and Sa (2006) argue that increases in U.S. demand for foreign goods and in the foreign demand for U.S. assets are the two

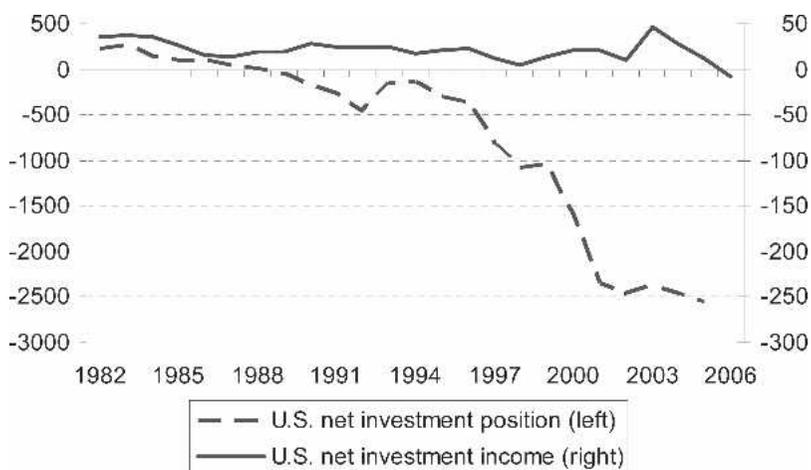
¹In effect, the global propensity to save has not increased; what has increased is the share of global savings invested in international versus local markets.

main forces behind the U.S. current account deficit. The large gradual depreciation of the dollar predicted by this model is driven by the simplifying assumption that the trade balance is a function of the real exchange rate alone. To restore equilibrium, the United States needs to generate a trade surplus to service the additional liabilities it issued in response to increased demand for U.S. assets.

“Exorbitant Privilege”

Gourinchas and Rey (2006) draw attention to the fact that the United States earns a higher return on its foreign assets (consisting mainly of equities and FDI) than it pays on its liabilities (mainly bank deposits and bonds). This fact explains why the U.S. investment income balance remained positive until 2006, even though the U.S. net international investment position turned strongly negative since the mid-1990s (Figure 2).² This “exorbitant privilege” (as DeGaulle famously called it in the 1960s) reflects the U.S. role as “banker of the

FIGURE 2
U.S. INTERNATIONAL POSITION AND INCOME
(Billions of Dollars)



SOURCE: Bureau of Economic Analysis; 2006 net income data refer to the first three quarters.

²In a variant, Hausmann and Sturzenegger (2005) argue that U.S. foreign assets would be much larger if measured by the present discounted value of future cash flows. By their calculation, the United States is a net creditor rather a net debtor.

world,” offering liquid, low-risk low-return assets while buying higher-yield assets from the rest of the world. In addition, dollar depreciation has a favorable impact on the U.S. net international investment position, because it raises the dollar value of assets (denominated primarily in foreign currencies) while leaving liabilities (denominated in U.S. dollars) unaffected. Gourinchas and Rey (2005) find that, historically, almost a third of U.S. external adjustment was realized through stabilizing valuation effects (the previously neglected “financial adjustment channel”) rather than through the traditional trade channel. This finding has important implications for the sustainability of the U.S. external deficit, especially in view of the huge increase in cross-border holdings compared with the past.

Correction of Imbalances is Under Way

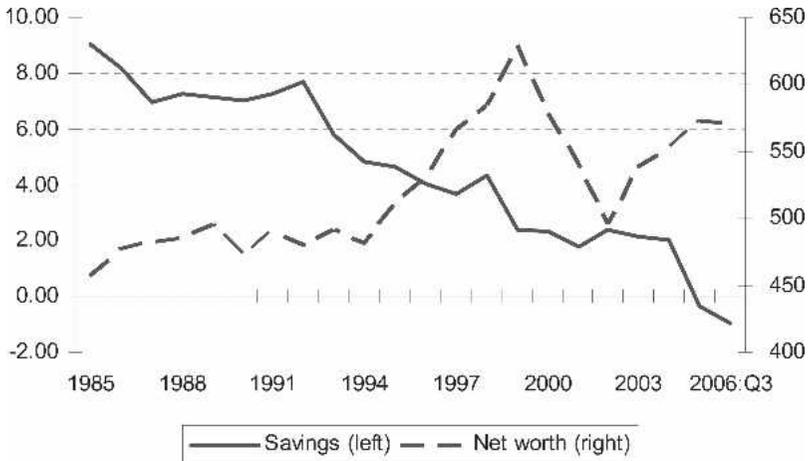
The theories summarized above present a contrarian view to the conventional wisdom predicting dire financial and economic consequences as a result of the imbalances. The fact that no such consequences have emerged in the past decade has only served to intensify the debate. Obviously the imbalances cannot keep widening indefinitely. Instead of a crash landing, however, I would argue that the imbalances are on their way to being corrected by the normal functioning of markets, and that this orderly correction would occur even in the absence of any G-7 policy initiatives.

First, global growth is getting more balanced, with the U.S. economy slowing and the Euro area and Japan picking up. A large part of the adjustment will come from shifts in aggregate demand in line with more balanced global growth.

Second, U.S. households will need to increase their savings from near-zero levels going forward, because their wealth is unlikely to continue to increase at the rapid pace recorded in the past decade. The Fed’s flow-of-funds data indicate that household wealth increased significantly in 1995–2000 due to the stock market boom; it also increased significantly in 2001–05 due to the housing market boom (from \$40.7 trillion to \$52.1 trillion). Neither of these two sources of wealth creation is likely to continue, as consensus forecasts predict a slowdown in corporate earnings in 2007 while the housing market has softened, leading to a leveling-off of household wealth in 2006 (Figure 3). Therefore U.S. households would probably need to save out of their incomes instead of relying on capital gains to increase their net worth. Moreover, the U.S. budget deficit is on its way to being gradually corrected.

As the above underlying causes fade out, the U.S. deficit will shrink

FIGURE 3
U.S. HOUSEHOLD SAVINGS AND NET WORTH
(% of Disposable Income)



SOURCES: Federal Reserve and Bureau of Economic Analysis.

with no need for any major G-7 policy initiatives or a risk of major financial market disruption. The problem with gloom-and-doom predictions is that they are usually based on real-side models that ignore capital flows, rather than on portfolio-balance models à la Caballero. These real-side models predict a need for a huge dollar depreciation to restore external balance because the traditional trade channel, characterized by low exchange rate elasticities, is by assumption the only channel for correction. They thus ignore the role of the U.S. current account deficit in providing needed dollar liquidity to the rest of the world (e.g., to pay for higher oil imports), which makes the U.S. current account deficit an integral and sustainable feature of a well-functioning international monetary system. They also ignore the unique depth and efficiency of U.S. capital markets and their attractiveness as a profitable and safe investment destination. Unlike the United States, which enjoys a dominant position as supplier of financial assets globally, emerging markets are subject to “sudden stops” because of the existence of foreign assets that can substitute for domestic assets at the drop of a hat.

Conclusion

Doomsday predictions about the dollar and interest rates, made year after year, have failed to materialize and are unconvincing. There

is no precedent of disorderly exchange rate adjustment in industrial countries with well-regulated financial systems that keep inflation under control. On the contrary, U.S. economic performance has been stellar and the global financial system remarkably stable, despite successive shocks (9/11, Iraq war, Enron, oil above \$70, Katrina, Refco, GM downgrade, Amaranth). The unprecedented decline in home bias and attendant increase in cross-border capital flows have made large external imbalances easier to finance. These imbalances are the natural by-product of financial globalization. Dollar misalignment is not the story here. The real effective exchange rate of the dollar peaked in February 2002 and is now just below its long-term average (Figure 1). Thus, calls for abandoning the U.S. “strong dollar” policy are misplaced (e.g., Feldstein 2006). Concerns about an abrupt unwinding thus appear unfounded.

The essence of the portfolio balance view of global imbalances is that capital flows are the result of portfolio optimization, and therefore cannot be analyzed by traditional trade balance models that only include flows as opposed to stocks. Once capital flows are endogenized, global imbalances become a benign and self-correcting phenomenon that needs no policy intervention to get resolved. The models constructed by Blanchard, Caballero, and Dooley, Folkerts-Landau, and Garber explain the imbalances without giving rise to any catastrophic event. The Revived Bretton Woods model explains the paradox of savings flowing from developing countries to the United States, as well as the low global interest rates, through mercantilist exchange rate undervaluation requiring accumulation of U.S. assets by central banks irrespective of relative returns. In effect, the United States, Asia, and much of the Middle East are part of the dollar zone, and therefore the imbalances between them are as irrelevant as those between Germany and Greece or Spain (whose imbalances are bigger than those between the United States and China relative to GDP). Obviously if Asian countries change their strategy and drop out of the dollar zone, their currencies will appreciate versus the dollar, thus reducing global imbalances. There is no reason to expect this process to be disorderly, however.

The International Monetary Fund views an abrupt unwinding of imbalances as a low-probability, high-cost event (IMF 2005, 2006). It has tried to design a cooperative strategy to help achieve a smooth unwinding of global imbalances, by encouraging the United States to raise its savings, Asia to rebalance its growth toward consumption and away from excessive reliance on exports, and the Euro area to undertake the structural reforms necessary to increase actual and potential growth. To encourage joint action, the IMF has introduced

multilateral consultations, designed to provide a forum in which the Fund can discuss systemic issues with several members at once. As discussed in this article, there are several ways to look at the same issue. Multilateral consultations are meant to foster a common understanding of the issues and of the policies needed to address them, if any.

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