Should Policy Makers Limit the Size of Current Account Imbalances?

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While the focus of talk about the global economic crisis has been on the financial sector and its problems, current account imbalances have also contributed to the instability the world is facing. Cian Ruane analyses these imbalances, why they exist and how they have impacted the world economy, concluding that it is necessary for policy makers to limit their size.

Introduction

Global current account imbalances have widened dramatically since the mid-1990s. In the 2000s a disorderly unwinding of global imbalances was seen as the greatest threat to global economic stability. The contribution of imbalances to the global financial crisis makes their persistence worrying for policy makers. Indeed, many of the structural issues that created these imbalances are still in place. This has led policy makers to consider whether international regulation is required. US Secretary of the Treasury Timothy Geithner proposed at the 2011 G20 meeting in Washington a limit on current account[1] (CA) surpluses and deficits of 4% of GDP (Cartapanis, 2011).

In this paper I argue that global imbalances are currently on an unsustainable path. Despite these imbalances being largely due to market distortions in developing countries, international cooperation and regulation will be required to stabilize the global economy in the medium-term.

In section one I discuss the framework of growth theory and examine the behaviour of global imbalances over the last 30 years. In section two I examine the argument that global imbalances were the underlying cause to the global financial crisis of 2008. In section three I evaluate the sustainability of the current path of global imbalances, and what risks they hold for the

1 In an open economy, the current account (CA) measures international transactions in goods, services and income. A CA deficit implies that a country is a net borrower, or that national savings don't meet investment demand.

global and European economies. Finally, in section four I detail the various mechanisms through which imbalances can correct themselves and consider the question of when policy makers should intervene to rebalance global current accounts.

Global Imbalances in Theory and in Practice

Classical growth theories provide a framework that can explain how global imbalances arise as a result of the normal functioning of the market. The prediction is that rational investors will invest in developing markets, in search of higher risk-adjusted returns (Feenstra and Taylor, 2011). The influx of capital into poor countries will lead to higher growth expectations, inducing consumers to consume more today. The increase in imports will lead to a CA deficit. What theory predicts, therefore, is a world where developing countries run CA deficits and advanced economies run CA surpluses. One should then see a convergence effect as developing economies grow quickly, lowering the marginal product of capital to the point that capital inflows start automatically rebalancing. This convergence effect should continue to take place so long as the Long-Run Budget Constraint is satisfied[2]. Countries can therefore run deficits for substantial periods of time, as their enhanced growth prospects will allow them to run CA surpluses in the future to pay back their debt. This was particularly evident in the European periphery from the period 1995-2008 (Lane and Pels, 2011).

Blanchard and Milesi-Ferretti (2010) differentiate between 'good' and 'bad' imbalances. For example, aging economies require more saving and hence will run CA surpluses. Also, capital will flow to where investment opportunities are best and also to where there are very liquid and deep financial markets. In this way, imbalances contribute to the efficient allocation of resources. Looking at the period 2000-2008, a significant proportion of surplus imbalances were run by oil-exporting countries that were responding to a higher price of oil and needed to hedge against future price volatility (indeed the price of oil did collapse at the beginning of the 2008 crisis).

We can therefore see that large CA imbalances can occur due to 'good' economic fundamentals and that global imbalances are not inherently 'bad' as is often suggested. Meddling in international balances can therefore have negative effects, not allowing countries to smooth consumption as they need and leading to inefficient investment. In general, policy makers need to be cautious when deciding whether imbalances need 'correcting' or not.

However, despite the evidence for convergence from Europe, glob-

2 According to the LRBC, an open economy's constraint differs from a closed economy's in that the net present value (NPV) of expenditure must equal the NPV of disposable income.

ally what we have seen over the last 20-30 years is an uphill flow of capital from poor to rich countries. This was famously brought to the fore in Lucas' paper 'Why Doesn't Capital Flow from Rich to Poor Countries' (1990). The predicted imbalances are therefore in reverse, with many advanced economies such as the US running consistent CA deficits while many emerging economies (particularly in emerging Asia) run CA surpluses.

Many explanations have been put forward to explain this. Lucas hypothesized that lower levels of human capital in developing countries, less advanced technology, worse institutions and political risk might all be contributing factors (1990). The current direction of imbalances can also be explained by distortions in emerging markets and advanced markets alike (Blanchard and Milesi-Ferretti, 2010). An exceedingly high savings rate in China is often explained by a lack of social insurance. Similarly, exceedingly high growth expectations in the US and in other advanced economies were seen to drive CA deficits in these countries by keeping savings rates low (Lane and Pels, 2011, Engel and Rogers, 2006). Another explanation is that developing countries, having suffered a sequence of currency crises in the 1980s and 1990s and built up large international reserves[3], are now focusing on export-led growth, artificially keeping their exchange rate depreciated and CA in surplus. Though these kinds of policy manipulations can be rational for an individual nation, they create systemic distortions and imbalances when a large group of countries behave in this way (Blanchard and Milesi-Ferretti, 2010).

Indeed what this state of the world illustrates is the difficulty in understanding the myriad of factors that determine global current accounts. Though policy makers manipulating their CA can be rational on an individual level, the imbalances created need not be 'good' imbalances and can create instability in the global economy. Indeed, we observe in the next section how these may have contributed to the crisis.

The Contribution of Global Imbalances to the Financial Crisis and its Aftermath

The Financial Crisis

Throughout the 2000s it was possible to divide the world into deficit and surplus countries. The main surplus countries included the oil-exporting countries, emerging Asia (China especially from mid-2000s on), and Germany.

3 These currency crises rendered countries very vulnerable to 'sudden stops' of capital. The results of these sudden stops were CA reversals that proved damaging to growth (Edwards, 2005). Capital movements and the CA are linked through the financial account, which is a measure of net changes of capital ownership. It is important to note that the presence of international reserves can result in the CA not being affected by capital flows in certain situations.

The deficit countries included the US and many European economies. The US deficit consistently increased throughout the 1990s and 2000s, from 4.3% in 2000 to 6% in 2006. This was of primary concern to policy makers, the main fear being a disorderly unwinding of global imbalances, causing a sudden depreciation of the dollar which would have massive repercussions for the global economy. Countries pegged to the dollar or holding large dollar reserves would be particularly affected.

However the crisis came from elsewhere, originating in the financial sector and in the 'shadow banking system'. Economists still debate the role of global imbalances in creating the crisis. Many had argued during the mid-2000s that the large US deficit was not actually a risk to global stability. Indeed, the large deficit could be explained by the backward financial system in many emerging markets, leading them to invest in the highly liquid US market (Dooley, Folkerts-Landau and Garber, 2005). This was a "win-win" situation which was completely harmless to the world economy. Others however claim that global imbalances were the underlying cause of the financial crisis (Portes, 2009).

As argued by Obstfeld and Rogoff (2009), I would agree that the global crisis was in itself a financial crisis. It originated in a highly leveraged financial sector that was kept in place by a financial asset bubble. Given the internationalisation of the banking sector, the crisis spread through financial channels, triggering banking and liquidity crises in many countries. That is not to say that global imbalances were not a contributing factor or that limits on global imbalances might not have reduced the size of the crisis or prevented it altogether.

An important factor in the crisis was how low global real rates were in the 2000s. This led to an underpricing of risk and cheap credit, fuelling asset bubbles and increasing leverage. Whether low global rates were due to high levels of saving in emerging Asia and China or the "Global Savings Glut" (GSG)[4], as argued respectively by Former US Treasury Secretary Henry Paulson and Chairman of the Fed Ben Bernanke, or due to the collapse of the technology bubble in the early 2000s (Obstfeld and Rogoff, 2009), the capital flows that helped finance the bubble in the US (causing a CA deficit) were due to CA surpluses in emerging Asia being refinanced into US debt.

Also significant were the low postponement costs in China and the US of correcting CA imbalances (Obstfeld and Rogoff, 2009). Indeed, as a surplus country it was not difficult for China to continue the sterilization pro-

4 This GSG was partially due to market distortions in emerging Asian economies, but also due to aging populations in more advanced economies such as Japan or Germany where there weren't sufficient domestic investment opportunities at home.

cess, and as a global reserve currency the US had the "exorbitant privilege" of being able to sustain levels of debt that would lead to investor panic for any emerging market (Roubini, 2010). Due to this, the US was not forced to rectify its budget deficits throughout the 2000s, and was not forced to take counter-cyclical fiscal policies that could have slowed the growth of the bubble. In short, whatever the 'underlying causes' of the crisis, I would argue that had CA limits been in place or attempts made to reduce imbalances the crisis may well have been of a lesser magnitude.

The Period 2008-2011

Global imbalances played an important role in determining how various countries were affected by and responded to the global crisis. As expected, the growth effects of the crisis were most severe for countries running large CA deficits[5] (Lane and Milesi-Ferretti, 2011). The global CA imbalances also played a role as a propagation mechanism for the crisis (BIR, 2011). The dramatic adjustment in the US CA (6% to 3%) meant that there was a sudden collapse in demand for goods from surplus countries. Emerging Asian and other surplus economies that were more or less insulated from the financial transmission mechanism of the crisis were therefore affected through the balance of payments mechanism.

However the most dramatic result that the crisis had was in accentuating the imbalances in the euro area. Throughout the 2000s, though the euro area as a whole tended towards a balanced CA, there were large surplus and deficit countries (Lane and Pels, 2010). There was therefore an asymmetry in terms of the shocks that both types of countries were subjected to when the financial crisis of 2008 hit. On the one hand, countries like Greece, Ireland and Spain that had not been running significant surpluses until then were forced to run pro-cyclical policies. The heterogeneity of the euro area meant that the ECB could not simultaneously keep rates at the right levels for core and periphery countries. Since then the sovereign debt crisis has led to voiced scepticism of the euro area's sustainability. Had CA balances been in check during this period it is likely that the euro area's crisis would not have become as severe as it currently is. Looking into the future, the euro area now knows that it will need either some form of fiscal union or a macro-prudential European supervisory authority if it is to remain a currency union.

The Sustainability of Current Imbalances and Risks for the Global

5 They also note that most of the adjustment was through expenditure compression as opposed to switching; the crisis hit overall demand, not just demand for foreign goods.

Economy

A lot of CA auto-adjustments have already taken place over the last three years. The US CA deficit shrank from 6% of GDP in 2006 to 3% following the crisis. Exchange rates have moved slowly, with a slight appreciation of the Renminbi contributing to this adjustment process (BIR, 2011). Equally, in Europe, pressures to pursue fiscal adjustments have led to a compression of current account imbalances (Lane and Milesi-Ferretti, 2011). However China is still running a very large CA surplus and a lot of structural problems remain; namely high savings in China, low savings in the US and currency manipulation for export-led growth in emerging markets (Blanchard and Milesi-Ferretti, 2010).

I agree with Roubini (2010) and Blanchard and Milesi-Ferretti (2010) that there are large risks for the future should global imbalances not correct themselves further. Firstly, the longer CA imbalances remain, the greater the risk of these leading to trade protectionism (BIR, 2011). Indeed, were Chinese exports to stay cheap for the US it might seem in US policy makers interest to introduce policies restricting the imports of Chinese goods. However, as was seen during the Great Depression, the effects of trade wars and protectionism can be devastating for the world economy. Another fear is that of a 'sudden stop' of capital flows to the US as investors lose faith in the USD. Obstfeld and Rogoff (2009) argue that investor faith in the US can no longer be taken for granted, and while the US has not seen any 'sudden stops' of capital, the S&P downgrade of US debt in summer 2011 is a worrying sign. They also argue that, while the US benefited from positive valuation effects on its external wealth prior to 2008, recent evidence has shown that these effects may well be going into reverse. If this were to happen it would further hurt US creditworthiness and increase the importance for the US to be able to run consistent surpluses.

The question is whether the path that current account imbalances will take without further policy maker intervention is sustainable. Indeed to ensure that none of the aforementioned dangers come to pass, we need to look at whether the auto-adjustments that are taking place will be sufficient to bring imbalances back onto a sustainable path.

There are many adjustment mechanisms that have already taken effect and may continue to do so. Continued but slow exchange rate appreciations in emerging Asia are likely, oil prices may stabilize reducing the surpluses run by oil exporting countries. Higher private saving in the US will continue as households try to deleverage, investment will fall, cross border premiums will rise and home bias will increase (Blanchard and Milesi-Fer-

retti, 2010). Though these may well stabilize current account balances at their current levels they are unlikely to cause dramatic corrections of imbalances in the short to medium term.

Even more dangerously, it can be argued that, while CA deficits pre-2008 were a sign of overheating, the scale of the compression of CA imbalances is due to undershooting (Lane and Milesi-Ferretti, 2011). In this case, these effects are cyclical and therefore temporary, meaning that further increases in imbalances are likely.

In light of the risks posed by global imbalances, and the uncertain nature of auto-correcting mechanisms functioning in the short to medium term, it is necessary for policy makers to intervene and find ways of correcting global imbalances.

Mechanisms of Rebalancing and Conclusion

From a national policy making perspective, the recent crisis has emphasized the importance of conducting monetary policy in a way that acknowledges the current account (Obstfeld and Rogoff, 2011). Had this been done in the US during the 2000s, as argued above the catastrophic consequences of the financial crisis might have been lessened. However national policy making that is effective in controlling global imbalances need to be done in both surplus and deficit countries for these changes to have significant effects. Not only that but there is an asymmetry between deficit and surplus countries' ability to control their own CA balances in the current environment (Cartapanis, 2011, Obstfeld and Rogoff, 2009). With the US in a recession, introducing policies that would reduce the CA deficit would also risk hurting recovery. However, it is not as difficult for surplus countries such as China to actively allow their currencies to appreciate, even though it would entail a slowdown in economic growth. The problem here, however, is that on a national level China faces short-term incentives to keep its surplus position as the world's largest exporter. Without some form of international agreement and negotiations it is unlikely that China will pursue this kind of policy independently. A trade-off with the US could be that the US commits to running tighter monetary policy, which would lessen the negative effects of China's exchange rate appreciation.

The CA surpluses in emerging Asian economies are another side of the imbalance that needs to be addressed. These countries have developed strong external positions in order to protect themselves from the risk of currency crises or speculation. Blanchard and Milesi-Ferretti (2010) argue that these states should stop basing their economy on export-led growth and look

at more domestic investment strategies. They recommend an extension of liquidity provisions for these countries, potentially through the IMF's Flexible Credit Line.

The final issue to consider is the timing of macro-prudential regulation. Indeed, while Blanchard and Milesi-Ferretti have emphasized that a "failure to act on the remaining domestic and systemic distortions that caused imbalances would threaten the nascent recovery", Cartapanis has questioned the wisdom of introducing macro-prudential regulations at this stage of a recovery citing studies by Allen ('Global Imbalances: Causes Consequences and Possible Solutions', 2011) that these kind of reversals are often associated with lower growth. Both agree, however, that corrections in global imbalances will need to begin with the surplus nations.

Though the current path of global imbalances is unsustainable, there is not necessarily a need for current account limits to be formally laid down as long as there is an informal agreement between all major economies to behave in such a way as to not exacerbate global imbalances. However, as we have seen in a lot of cases, the incentives faced by individual nations diverge from what is required for global stability. In my opinion a formal limit of 4% of GDP, as suggested by Timothy Geithner, is required to ensure that global imbalances begin to correct themselves. How this sort of limit should be enforced goes beyond the scope of this paper, however one consideration one would be the existence of a sunset clause, whereby the limits expire after 5/10 years. While the global economy may require CA limits now, these may well become a hindrance in the future and political pressure will not be enough to maintain them indefinitely.

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