Global Imbalances

The risks posed by large and increasingly unsustainable current account imbalances dominated the international economic debate before the onset of the global financial crisis. As a result of the crisis, there have been significant changes in saving and investment patterns across the world and imbalances have narrowed considerably. Does this mean that imbalances are a problem of the past? Hardly, as argued in a recent article by Messrs. Blanchard and Milesi-Ferretti of the IMF (available at http://www.imf.org/external/pubs/ft/spn/2009/spn0929.pdf).

Fundamentally, the current account position reflects the difference between a country's national savings and investment. If the former exceeds the latter, the country has a current account surplus and supplies the excess funds as financing to those countries that have a deficit.

To be clear, there is no reason for current accounts to be balanced. But, there are "good" and "bad" reasons for current account imbalances. Typical examples of good reasons include (i) a country whose population is aging faster than elsewhere wants to save and run current account surpluses in anticipation of the dissaving that will occur once the workforce shrinks and the number of retirees rises; (ii) a country with attractive investment opportunities may draw savings from more mature economies, and thus run a current account deficit; and (iii) a country that has deeper and more liquid financial markets may attract more investor appetite, generating currency appreciation and a current account deficit. In all these cases, it would be unwise to want to reduce imbalances as they reflect the optimal allocation of capital across time and space.

But imbalances can be symptoms of underlying distortions. Examples of such bad reasons for imbalances in savings and investment include (i) weak social insurance leading to high precautionary savings; (ii) asset-price booms or overly optimistic expectations of future income growth leading to low private savings; (iii) poor protection of property rights or lack of competition in the financial sector can lead to excessively low investment. In all these cases, the purpose of policies should be to reduce the underlying distortions, mitigating imbalances along the way.

There are other distortions that can lead to imbalances. For example, particularly following the Asian crisis, many emerging economies have run large current account surpluses and accumulated very substantial foreign exchange reserves. One motive for the accumulation of reserves has been self-insurance. While this may be rational at the individual country level, and may have contributed to resilience during the crisis, it is globally inefficient relative to alternative arrangements, such as the establishment of credit lines, reserve-pooling arrangements, swap lines, or other forms of insurance.

Messrs. Blanchard and Milesi-Ferretti's article also suggests that imbalances started to take off in 1996. From 1996-2000, imbalances were largely a relative profitability story. On one side, U.S. investment increased, linked to the high tech boom and expectations of higher productivity growth. And, on the other side, investment in East Asia decreased following the aftermath of the Asian crisis and Japan's protracted recession. In the second period, from 2001-2004, rising imbalances reflected lower U.S. savings particularly because of rising government deficits. At the same time, the number of surplus countries increased, which included Japan and emerging Asia, oil exporters (due to rising oil prices), and parts of Europe (reflecting low investment). In the third period, from 2005-2008, asset booms played an increasingly important role in reducing household savings in several advanced economies, while rising oil prices and the desire for reserve accumulation further strengthened current accounts in surplus countries.

So are these imbalances good or bad? During the first period, mostly good as it reflected the reallocation of capital in response to perceived differences in profitability. In the second period, the verdict is more mixed with the main driver (U.S. fiscal deficits) "bad" while widening surpluses by oil exporters was reasonable, in light of the uncertainty about future price dynamics and the exhaustible nature of oil. Particularly during the third period, the imbalances were increasingly "bad", driven by "financial excesses" that eventually led to the current financial crisis.

In 2009, there was a substantial reduction in imbalances reflecting the sharp decline in oil prices, asset-price busts leading to a contraction in imports in deficit countries, and a diminished appetite from surplus countries to finance large net external imbalances.

Some of these factors are likely to be transitory, as growth recovers (increasing imbalances) and fiscal stimulus is withdrawn (reducing imbalances). Other factors are likely to be long lasting. For example, private saving in deficit countries is projected to be generally higher than before the crisis as wealth has been eroded. Investment rates are likely to be significantly lower in several countries than they were before the crisis. Risk premia are likely to remain above pre-crisis levels.

Nevertheless, current forecasts suggest that the world still needs to grapple with remaining imbalances, by mitigating the outstanding domestic and international distortions. These include, higher private and public U.S. saving, increasing social protection and access to credit for households in countries such as China, and a move towards more domestic-demand led growth in a number of emerging market economies and commodity-exporting countries if oil prices remain high. Further strengthening global, emergency, liquidity provision arrangements, including by the IMF, would reduce the need for self insurance through reserve accumulation.

International cooperation remains key to reduce imbalances in an orderly manner while maintaining global growth momentum. Failure to do so could result in the world economy being stuck in "midstream," threatening the sustainability of the recovery.