

Box 1

GLOBAL IMBALANCES: RECENT DEVELOPMENTS AND POLICY REQUIREMENTS

The diverging pattern of current account positions that have been observed at the global level for a number of years raises two important questions. First, while it can be expected that some countries may run deficits for a considerable period of time, the fact that the world's largest economy is recording increasingly large deficits – currently absorbing around 75% of world net savings – has a material effect on global trade and financial patterns (Chart A). Indeed, the continuing accumulation of large deficits, even if they can be easily financed in the short to medium term, will eventually lead to the accumulation of large and likely unsustainable levels of net foreign liabilities, which needs to be addressed. Second, the fact that most emerging markets run current account surpluses and the United States a deficit is, in many respects, puzzling, since it implies that spending by one of the world's richest economies is financed by economies with far lower income levels.¹ While there is no agreed benchmark to assess the optimality of private agents' investment decisions, the fact that the public sector plays an important role in the current pattern of global imbalances – through the stance of macroeconomic

¹ According to standard neoclassical macroeconomic theory, capital should actually flow from rich countries to poor countries, where returns are higher. Several explanations have been provided, highlighting the possibility that emerging market economies may have reduced capacity to absorb foreign savings. See, for instance, E. Prasad, R. Rajan and A. Subramaniam (2006), "Patterns of international capital flows and their implications for economic development", IMF Research Department.

policies or the large accumulation of foreign exchange reserves – calls for a careful assessment of the factors behind these imbalances.

The resolution of current account imbalances is complicated by the complex nature of the balance of payments. While the saving-investment perspective of the current account highlights the role of domestic factors in the adjustment, the financial account perspective emphasises the role of foreign residents, including central banks. Against this background, this box first reviews the current account developments in the world's main economic regions and then turns to selected cross-border issues, focusing in particular on the structure of US net foreign liabilities and on recent exchange rate developments.

Current account developments in the world's main economic regions

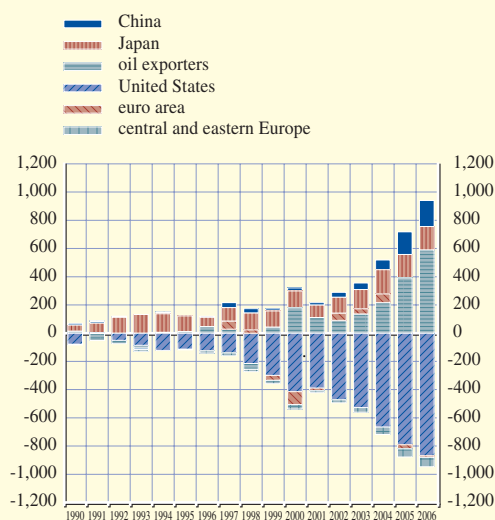
In the United States, the current account deficit has recorded a substantial increase in recent years, from less than 4% of GDP in 2001 to nearly 7% in 2006. This rise was mostly accounted for by a fall in net domestic saving, from 4% to almost 0%, which stemmed mostly from the household and public sectors. Meanwhile, investment decreased markedly in the early 2000s, but has partially recovered over the last three years. Although an increase in government net saving is likely to result partly in a decrease in private saving (the so-called Ricardian effect), on the whole it is expected to lower the current account deficit.

By contrast, China has been running high and increasing current account surpluses due, in particular, to its very robust export performance and, more recently, to a deceleration in imports. Between 2000 and 2005 China's import share in all large foreign markets increased, rising from around 5% to 10% in the euro area, from below 9% to 15% in the United States and from 14.5% to 21% in Japan. These gains can be related to the price competitiveness of Chinese exports and the economy's role in processing trade from components imported from the rest of Asia. This also raises the question of the undervaluation of the renminbi, which is by now documented in several studies (even if they tend to report very heterogeneous estimates).² The noticeable increase in China's current account surplus can be associated, in particular, with a rapid increase in domestic saving, which has risen from 35% of GDP in 2000 to currently above 50%. Domestic investment has also risen over this period, albeit at a slower pace.

The current account position of the euro area has remained broadly balanced in recent years (see Chart 30 in Section 5). As of August 2006, the 12-month cumulated euro area current

Chart A Current account positions for selected regions

(USD billions)



Source: IMF's World Economic Outlook (estimates for 2006).

² Such estimates can be found, for instance, in G. Chang, and Q. Shao, "How much is the Chinese currency undervalued? A quantitative estimation", *China Economic Review*, 15, 2004, 366-371; S. Dunaway et al., "How Robust are Estimates of Equilibrium Real Exchange Rates: The Case of China", IMF WP 06/220 and J. Frankel, "On the renminbi", CESifo Forum 3/2005.

account deficit vis-à-vis the rest of the world reached around 0.5% of GDP. However, this does not imply that the euro area has no role in the resolution of global imbalances. The euro area being a large and open economy (it is the world's largest exporter, accounting for 17.5% of total exports, and the world's second largest importer after the United States), it can, through higher potential growth, participate in the global rebalancing process.

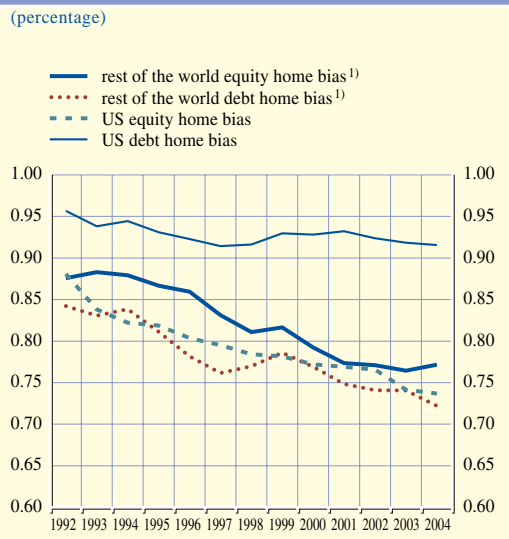
Japan, whose current account surplus increased from 2.1% of GDP in 2001 to 3.8% in 2004 and 3.6% in 2005, also has a role to play in the unwinding of global imbalances. The rise in Japan's current account surplus can be attributed to a fall in investment in the early 2000s, while savings started to increase in 2003. The gross domestic saving rate in Japan – currently 27% of GDP – is significantly above that of other large advanced economies (e.g. 13% in the United States, 20% in the euro area).

Finally, oil-exporting countries account for an increasing share of global imbalances. Since the early 2000s they have registered rising current account surpluses and account, with a surplus of nearly USD 600 billion in 2006, for the highest share of these surpluses. The large increase in the trade balance corresponds very closely to the rise in oil prices recorded over the period. The associated windfall revenues have resulted in an increase in savings, which now represent over 35% of GDP, whereas aggregate investment has remained broadly stable at around 20% of GDP over this period.

Global financing patterns underlying imbalances

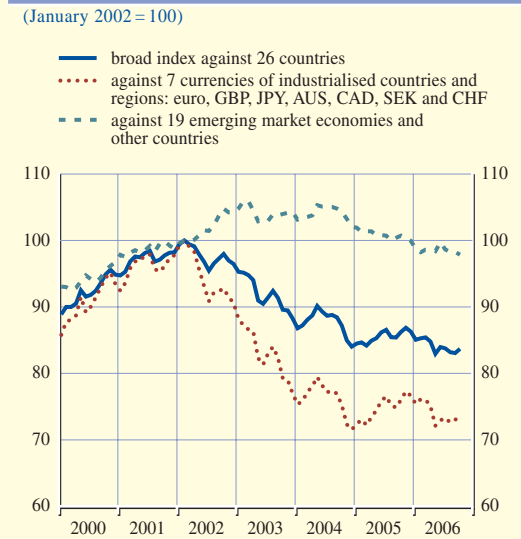
Cross-border financial issues are another essential dimension of global imbalances. From the perspective of cross-border capital flows, the financing of the US current account deficit has been facilitated by three factors. First, the US economy has been very dynamic in recent years

Chart B Equity and debt home bias



Source: ECB calculations based on IMF's International Financial Statistics and Standard and Poor's Global Stock Markets Factbook.
1) Rest of the world relates to the world excluding the United States.

Chart C US dollar nominal effective exchange rate



Source: Federal Reserve System and ECB staff calculations.

and has registered productivity gains above 2% per year since 1996. A second potential factor is related to the evolution of portfolio home bias³ in the United States and abroad (some ECB staff estimates are reported in Chart B). Since 1992, the aggregate home bias of countries other than the United States has continuously declined both for equity (by around 10%) and for debt securities (by around 12%). This is consistent with the fact that non-US residents have been willing to purchase US debt securities, although the returns on US debt assets have been low for most of the period under consideration. Taking a US perspective, home bias has also decreased, albeit significantly more for equity (by around 14%) than for debt, for which it remains above 90%. The decrease in US home bias for equity is consistent with the fact that US purchases of foreign equities have generally strengthened, while interest from US investors in debt issued abroad has remained lacklustre.⁴ Third, asymmetries in the portfolio holdings of US and foreign residents are key to capturing another important feature of US debt dynamics. Indeed, for the United States, the stock of net foreign liabilities (around 22% of GDP) is substantially lower than accumulated past current account positions (above 40%), although over the long run the two should, in theory, correspond. A significant part of this difference relates to substantial valuation gains, stemming from return differentials on investment in the United States and abroad, and to exchange rate changes.

One of the counterparts of the financing of the US current account deficit has been the accumulation of foreign reserves by other countries, which in the recent period mostly comprise the oil-exporting countries and China.⁵ In the case of the oil exporters, the accumulation of low interest-bearing reserves partly reflects limited domestic investment opportunities. However, progress has been made in recent years with the development of oil and heritage funds and local stock exchange markets. In the case of China, the large accumulation of international reserves since the early 2000s (increasing from around USD 150 billion at the beginning of 2000 to nearly USD 1 trillion today) raises several issues concerning the conduct of monetary policy. Indeed, the People's Bank of China has had to increasingly sterilise the domestic monetary expansion resulting from foreign exchange intervention. In addition to the risk of valuation losses in the balance sheet of the monetary authorities, the current arrangement limits the extent to which monetary policy can address domestic issues, in particular those related to the risk of overheating in the Chinese economy.

Turning to exchange rate developments, the US dollar has depreciated by around 16% in nominal effective terms – as measured against the currencies of 26 trading partners – since 2002 (see Chart C). This reflects very different changes across groups of countries: against the currencies of seven major industrialised countries and regions together, the US dollar has depreciated by as much as 26%, whereas it has remained broadly stable against the currencies of most emerging market economies. This pattern reflects the fact that many of the countries in the latter group maintain de facto pegged or tightly managed exchange rates with the US dollar. This observation has led to greater calls for actual exchange rate flexibility in emerging economies, which nowadays account for roughly 45% of trade with the United States.

3 The concept of home bias refers to the fact that investors worldwide seem to be excessively investing in their home country. For a given country, having no home bias would imply that the share of foreign financial assets in its portfolio is equal to the share of the rest of the world's financial market capitalisation in world market capitalisation.

4 See Federal Reserve Bulletin "Understanding U.S. Cross-Border Securities Data", May 2006.

5 Note: the figures on international reserves of oil exporters may not be directly comparable, as different countries follow different practices regarding their investments, including through oil stabilisation funds.

Conclusions

The considerations above underscore the policy adjustments called for in the communiqués of the G7, G20 and the International Monetary and Financial Committee (IMFC). For the United States, these adjustments consist in raising national savings in both the public and private sectors. The euro area and Japan have a key role to play through reforms that aim to increase domestic productivity and potential growth. Indeed, euro area productivity gains, especially in the non-traded sector, could strengthen domestic demand, thereby stimulating imports. In China and other emerging markets, especially in Asia, moves towards a more flexible exchange rate arrangement and financial development that would lower precautionary saving and raise consumer spending would not only contribute to the resolution of global imbalances but also successfully address domestic issues. Finally, oil-exporting countries would significantly benefit from further developments of domestic investment opportunities. It is important to stress that these domestic policies are not only supportive of a gradual adjustment of global imbalances over the medium term, but are also in the domestic interest of the economies concerned.