Contemporary Developments of Global Imbalances

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Summary: This paper analyzes the contemporary developments of global imbalances. At the beginning of the analysis global imbalances are explained as a macroeconomic phenomenon. Further on the paper explains the key determinants of imbalances – the factors that stand behind the accumulations of surpluses or deficits. Furthermore the development of the problem in the period 1996-2011 is considered, and several sub-periods are differentiated. The emphasis is put on the post-crisis developments, i.e. the correction in imbalances after 2008, the reasons for the correction, the remaining distortions and the necessary policy measures that yet need to be taken. The paper concludes that despite the correction and the healthy adjustment there are still problems that need to be addressed so that the built-up of serious imbalances in the future is prevented.

Key words: global imbalances, current account deficit, current account surplus, factors, correction.

JEL: F21, F32, F44.

1. Introduction

The global imbalances represent a complex macroeconomic phenomenon which is a result of the interaction of multiple factors. The factors range from the price of commodities as oil to factors such as economic policy, demographic structure, savings and investment patterns across countries, attitude towards risk, growth expectations and other issues. The problem is manifested as a group of countries run large and persistent current account surpluses, while others bear the burden of huge current account deficits. As per the definition of the International Monetary Fund (IMF), global external imbalances are "current accounts different from those warranted by fundamentals and desirable policies". As such, the global imbalances reflect the combined effect of external policies (like foreign exchange reserves policy or capital flow management), internal policies (fiscal policies) and fundamentals (such as level of economic development, demographic structure and etc.).

There is a debate in economic literature on whether or not the global imbalances are a natural and benign phenomenon or, on the contrary, represent a serious threat

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to global economic stability. Some authors like Cooper (2007) and Dooley et al. (2005) share the view that the global imbalances are a benign phenomenon and an inevitable result of the low level of development of the emerging economies' financial markets. They look at the imbalances as a kind of consensus between developing economies, seeking safety for their savings and the rich developed economies, seeking cheap financing of their growing needs. Some others like Blanchard et al. (2009) take a more balanced view, namely that imbalances are not necessarily a negative phenomenon. They claim that imbalances can be a natural result of the flow of savings towards locations where they can be more productively utilized. The different behavior of savers and the different rate of return of capital are the other natural explanations of the emergence of "good" imbalances. Still the authors recognize that imbalances can pose a serious problem when they are in place for a long time and tend to narrow rather than deepen. It is so because behind the imbalances there is a mixture of domestic and systemic distortions that should be addressed.

Such controversy exists as well in the views of economists on the link between the global imbalances and the financial crisis. The most acceptable and well-defended view is that imbalances were not the factor for but a symptom of the crisis, which was actually caused by poor financial supervision and loose monetary policies. This is not to say that global imbalances have nothing to do with the financial crisis. On the contrary, the existence of large and persistent global imbalances contributed to the deepening global vulnerabilities.

The statistical data shows deepening of the global imbalances since the mid 1990s of the past century until the onset of the global financial and economic crisis (with a minor correction in 2001-2002). The imbalances peaked in 2006, reaching about 3% of the global GDP, due to the upward cyclical development, but also due to existing distortions. As a result of the financial crisis and the changes in the resultant savings and investments patterns, the imbalances have narrowed in the period 2008-2011. The greatest correction of imbalances was registered in 2009, while in 2010 and 2011 imbalances slightly increased again as a result of the rise of commodity prices. The current account deficits in USA, Greece, Ireland, Portugal, England, Spain and other developing economies in Europe that comprised the main part of the pre-crisis deficits have shrunk. At the same time the current account surpluses of China and of the oil exporting countries are also shrinking. Yet is such a situation likely to be preserved in the long run and can we expect that once the global economy returns to growth the global imbalances would not deepen again? The key question here is whether or not the underlying problems that determine the imbalances are addressed and corrected.

Here below I look at the key determinants of imbalances – the factors that stand behind the accumulations of surpluses or deficits. Furthermore I look at the development of the problem in the period 1996-2011 with an emphasis on the post-crisis developments.

2. What makes some countries to accumulate surpluses while other run deficits on their current accounts?

Nearly two thirds of the pre-crisis global surpluses were accumulated by the oil exporting countries, China and some other Asian economies. The remaining one third of the surpluses could be attributed to the developed economies, mainly Germany and Japan. For the sake of comparison, in the 1990s the surpluses were concentrated mainly in Japan and some European economies. The accumulation of surpluses, e.g. the existence of internal savings that exceed internal investments, can be explained with any of the following factors:

- Precautionary motive or self-insurance against crisis. This is a key motive for countries that in the last decades have gone through serious balance of payments crisis. Such countries have bitter memories and therefore aim at the accumulation of a sufficient amount of foreign exchange reserves to serve as an anti-crisis buffer and make them independent of IMF aid. This is especially true in the case of volatile capital flows, hot money and abrupt reversals. According to some estimates, nearly two thirds of the current volume of foreign exchange reserves is due to the precautionary motive. Although this can be seen as a rational behavior for a separate country, the holding of large amount of foreign exchange reserves is ineffective and expensive from a global perspective, given other crisis prevention mechanisms such as credit lines, foreign exchange swaps and others.
- Export-led growth strategies*:* in some cases the accumulation of current account surpluses is due to an export-led growth strategy, pursued by the government. Such strategies are usually adopted by countries that deem internal demand as insufficient to boost economic growth. This kind of policy can be characterized with maintenance of an undervalued national currency, support for the exporting companies and the tradable sector, while at the same time measures for suppression of the domestic demand are adopted, so that overheating and inflation be prevented. Foreign exchange market interventions are a natural ingredient of such a policy, aiming to prevent national currency appreciation. As a result foreign currency reserves are accumulated. Although such kind of strategies seem rational from the a country's perspective, they are by nature harmful for the country's trade partners and for the non-tradable sector of the economy. If such policies are adopted simultaneously by countries with a significant share in the world trade, they can be very harmful for the global economy. This is how the accumulation of current account surpluses in China and some East Asian economies can be accounted for.
- Inadequately developed social safety nets: the insufficiently developed social safety nets can explain the excessive savings by households.
- Poor corporate governance: the poor corporate governance can make companies retain and reinvest their earnings.

- Intertemporal consumption smoothing[1]: This motive refers mainly to Middle East oil exporting countries, which use the revenues from oil exports in times of high oil prices to accumulate financial assets (in the form of Sovereign Wealth Funds), at the expense of low current consumption.
- The financial assets shortage hypothesis*:* the underdeveloped and inefficient financial markets in some countries do not provide the public with suitable financial instruments for savings and borrowing, which could allow consumption smoothing and risk protection. This situation suppresses internal consumption and stimulates excessive savings. In some countries (like China and India) a significant part of the population does not even have access to financial services.
- Political reasons: some countries accumulate foreign exchange reserves just as a manifestation of their growing economic power.
- Growing competitiveness: this reason can explain the accumulation of current account surpluses by developed economies, especially Germany. After a long period of adjustment following the unification of West and East Germany, the country increased its competitiveness and became one of the leading world exporters.
- Ageing population: some developed countries are facing serious problems with their ageing population that exposes their pension systems to risk. For them the current account surpluses serve as a buffer against shocks.
- The natural counterpart to the current account surpluses are the deficits in the current accounts of some other countries. Nearly two thirds of the global current account deficit is due to the USA, while one forth is accumulated by European economies. A deficit in the current account is due to internal investments exceeding internal savings and can be explained with any of the following factors:
- Expansionary monetary policy: at the turn of the 21st century, after the recession in 2001, the interest rates in USA and in many other regions across the world are set at very low levels, which they retain for a long period of time. These low interest rates discouraged savings and stimulated the high internal consumption in USA that lead to a significant increase in asset prices and high leverage. These factors in combination with the financial innovations and the serious omissions in the financial markets regulation set the basis for the sub-prime mortgage crisis in USA in 2007 that escalated into a global financial and economic crisis.
- "The global savings glut"[2]: there is such a concept, popularized by the the Federal Reserve Governor Ben Bernanke in one of his famous speeches, in which he maintains that the high demand for safe financial assets and the so called "flight to quality" have spurred capital inflows in USA and a

[1] Intertemporal consumption smoothing is a notion referring to the balancing of savings and consumption in one man's lifecycle, aiming to achieve a good living standard.
"The Global Saving Glut and the U.S. Current Account Deficit", speech given by Governor Ben Bernanke on March 10, 2005, at the Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia.

reduction in interest rates, which explains the current account deficit. According to Governor Ben Bernanke, the "savings glut" after 2000 is a result of many factors and events. On one hand there is a strong motivation for savings in the developed countries with ageing population. On the other hand, a more significant reason for the surge in savings is the reversal of the capital flows and the transformation of the developing world from net consumer into a net supplier of capital into the international capital markets.

- The high demand for foreign exchange reserves*:* Although in the 1970s the international monetary system switched from fixed to floating exchange rates, many states continue to show great "appetite" for foreign exchange reserves. In its attempts to satisfy this "appetite" the country that issues the key reserve currency is facing a serious challenge. In the case of the USA demand should be met by supplying the rest of the world with an adequate quantity of foreign exchange reserves, while simultaneously maintaining an internal and external balance so that those reserves are of high quality. Thus the significant demand for reserves on a global scale results in accumulation of high national debt, in issuing the reserve currency, which in turn calls into question the quality of the reserves. This contradiction, intrinsic to a monetary system based on one dominant currency, as explained by the Triffin paradox*,* is still valid today.

Most of those reasons for the accumulation of current account surpluses and deficits are interdependent. For example the high rates of economic growth in China and other developing economies set the pattern of soaring prices of oil and other commodities, which causes growing current account deficits of the oil importing countries and accordingly increases the surpluses of the oil exporting states. The abundance of savings brings down interest rates and prompts the formation of asset "bubbles". The demand for safe reserve assets from surplus countries produces deficit in the current account of the state that supplies the assets.

3. Development of the global imbalances since the mid 1990s of the past century until present days. The effects of the crisis.

This analysis elaborates upon the development of the global imbalances since the mid 1990s of the past century up to 2011. This long period of time can be divided into four sub-periods, not only for methodological purposes, but also because the factors that determine the formation and development of imbalances during the sub-periods are different. In the period 1996-2008 the problem worsens, imbalances grow and their nature changes. In 2008-2011 a correction in the global imbalances can be noticed but the problem persists.

In the sub-period 1996-2000 the global imbalances reflect the process of redistribution and redirection of capital flows in response to the expected changes in capital productivity. The positive expectations for a rise in productivity as a result of the technological boom attracted a lot of investments in USA. On the other hand, the investments in East

Asia subsided following the financial crisis in the region and the prolonged recession in Japan. As a consequence of the investments' relocation the USA current account registered deficit that reached 0.8% of the world GDP, while at the same time Japan and East Asian countries registered surpluses in their current account that stood at 0.4% of world GDP (see Table 1). The US capital inflows were predominantly in the form of foreign direct investments or portfolio investments.

During the next period (2001-2004) the situation exacerbated due to a serious fall in savings in the USA. The household savings in USA also dropped because of increased borrowing amid real estate price hikes. As a result the US current account deficit reached 1.4% of the world GDP in this period. On the surplus side, the oil-exporting countries joined the Asian economies, due to the increase in the oil prices. Countries from "core Europe" also joined the surplus group, as the investments in this region decreased. The nature of capital flows also changed in this period. The share of the debt needed to finance the US current account deficit increased while the share of equity decreased. A process of expansion of deficits in the current accounts of Europe's "periphery" started.

The pre-crisis 2005-2008 sub-period can be briefly characterized with asset "bubbles" and rising asset prices, increased spending and low savings. In USA the current account deficit remained at the level of 1,4% of the world GDP. In Europe Spain, Ireland, United Kingdom and some Central and East European economies joined USA with deficits that stood at a total of 0.8% of world GDP. Those deficits were also due to increased consumption and investments as a result of hike in asset prices.

On the other side of the problem, China accumulated large current account surplus during those years (0.6 % of the world GDP compared to 0.1 % for the previous sub-period). The increase in the China's surplus was due to an increase in savings.

Table 1. Average current account balances (% of world GDP)

	1996-2000	2001-2004	2005-2008
United States	-0.8	-1.4	-1.4
Europe deficit[1]	-0.1	-0.4	-0.8
Rest of the world[1]	-0.3	0.0	-0.3
China	0.1	0.1	0.6
Emerging Asia[1]	0.1	0.2	0.2
Japan	0.3	0.3	0.3
Oil Exporters[1]	0.2	0.4	1
Europe surplus[1]	0.2	0.4	0.7
Discrepancy	-0.3	-0.3	0.4

Source: IMF, "Global Imbalances: In Midstream?", IMF Staff Position Note 09/2009

Table 2. Current Account Balance (% of GDP) for selected countries in 2008-2011

County/Year	2008	2009	2010	2011
Germany	6.2	6.0	6.1	5.6
Sweden	9.4	7.1	6.4	6.5
Netherlands	4.4	5.2	7.8	9.7
China	9.3	4.9	4.0	2.8
Malaysia	16.8	15.7	11.1	11.0
Thailand	0.8	8.3	4.1	-
Japan	3.3	2.9	3.7	2.0
Russia	6.2	4.0	4.8	5.3
USA	-4.8	-2.7	-3.3	-3.2
United Kingdom	-1.6	-1.7	-3.3	-1.9
Brazil	-1.7	-1.5	-2.2	-2.1
Turkey	-5.7	-2.2	-6.4	-10
Australia	-4.5	-4.8	-2.8	-
Canada	0.4	-3.0	-3.1	-2.8
Italy	-2.8	-1.9	-3.6	-3.1
France	-1.8	-1.4	-1.6	-2.0
Spain	-9.7	-4.8	-4.6	-3.5
South Africa	-7.3	-4.0	-2.8	-3.4

Source: World Bank

The oil-exporting countries' surpluses also rose. "Core" Europe continued to register surpluses, while Asian surpluses corrected a bit due to the rising commodity prices. The capital flows increased, as the debt capital flows took a major share.

Definition of country groups:

Europe surplus: Austria, Belgium, Denmark, Finland, Germany, Luxemburg, Netherlands, Sweden, Switzerland

Europe deficit: Greece, Ireland, Italy, Portugal, Spain, UK, Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Turkey, Ukraine

Emerging Asia: Honk Kong S.A.R. of China, Indonesia, Korea, Malaysia, Philippines, Taiwan, Thailand

Oil Exporters: Algeria, Angola, Azerbaijan, Bahrain, Republic of Congo, Equatorial Guinea, Gabon, Iran, Kazakhstan, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Sudan, Syria, Trinidad and Tobago, United Arab Emirates, Venezuela, Yemen

Rest of the World: the remaining countries

With the onset of the global financial and economic crisis, a significant correction of global imbalances started that continued throughout sub-period 2009-2011. This correction is due to change in the expectations of economic agents, in the savings and investments patterns and in commodity prices.

An authoritative source of information on the post-crisis evolution of global imbalances is the IMF Pilot External Sector Report[3]. The conclusion, contained in this report, is that there has been a significant narrowing of imbalances, which has been accompanied by healthier adjustments, such as improved fiscal balances, resilient domestic demand in China and increased social spending in oil-exporting countries. From the peak of about 3% of global GDP in 2006, the global imbalances stood at about 2% of global GDP in 2011. Nevertheless the IMF staff considers that despite the correction, the imbalances and vulnerabilities still remain above desirable levels and are likely to persist, unless decisive measures are taken by the governments and the appropriate policies are adopted. The correction comes predominantly because of the weaker domestic demand from current account deficit economies hit by the crisis rather than from the stronger demand by the surplus economies.

The fact that the underlying distortions are not yet remedied is evident in the data, showing that for countries like Germany, Sweden, Netherlands, China, Indonesia, Malaysia, Singapore, Thailand and Korea the current accounts are stronger and the real effective exchange rates of their currencies lower than those consistent with fundamentals, as estimated by IMF staff. Those imbalances are fully offset by weaker current accounts and overvalued real effective exchange rates for Brazil, Turkey, Russia, South Africa, USA, Japan, United Kingdom, Australia, Canada, Italy, Spain, France and European emerging markets (See Table 2).

The IMF External Sector Report identifies also the key policy measures that still need to be taken, so that the current account balances are consistent with fundamentals. Those measures are directed at rectifying the underlying distortions that determine the imbalances. Here are the recommended policy measures that should be adopted:

- Large fiscal consolidation in the major developed economies. This measure will not only lead to an improvement of the current accounts of those countries (USA, United Kingdom, Italy, Spain and etc.) but will also lower current account surpluses elsewhere.
- As per the IMF staff estimates the current levels of foreign exchange reserves for some emerging markets are above the adequate levels for precautionary purposes. Therefore the Fund recommends that such countries refrain from foreign exchange interventions and allow greater exchange rate flexibility.
- The third recommendation refers to the desired adjustments of structural policies, which are considered by IMF to be the most important factor for limiting external imbalances. Such structural policies include: the improvement of the level of social protection, which is expected to reduce the level of household saving for precautionary purposes; careful loosening of the capital account restrictions accompanied by strengthening of the global financial regulation to improve the allocation of savings; and structural reforms of labor and product markets to possibly boost productivity (especially important for peripheral Europe).

[3] IMF Pilot External Sector Report, 2012, IMF Policy Paper, July 2, 2012

4. Conclusion

The global imbalances represent a complex macroeconomic phenomenon that is a reflection of a myriad of factors and the interaction between those factors. Although they can be viewed as a natural phenomenon, the built up of large imbalances jeopardizes the balanced world economic development. The history of the development of the global imbalances since the mid 1990s of the 20th century until the present days is evidence to this effect.

The crisis brought a correction of the global imbalances and largely prompted the policy responses needed to tackle the problems with the underlying distortions. Nevertheless the distortions persist and further policy efforts are needed to avert a possible built up of huge imbalances. Such policies will provide for and speed up the balanced recovery of the global economy.

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