

# Identifying and Reducing Global Current Account Imbalances

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# Outline

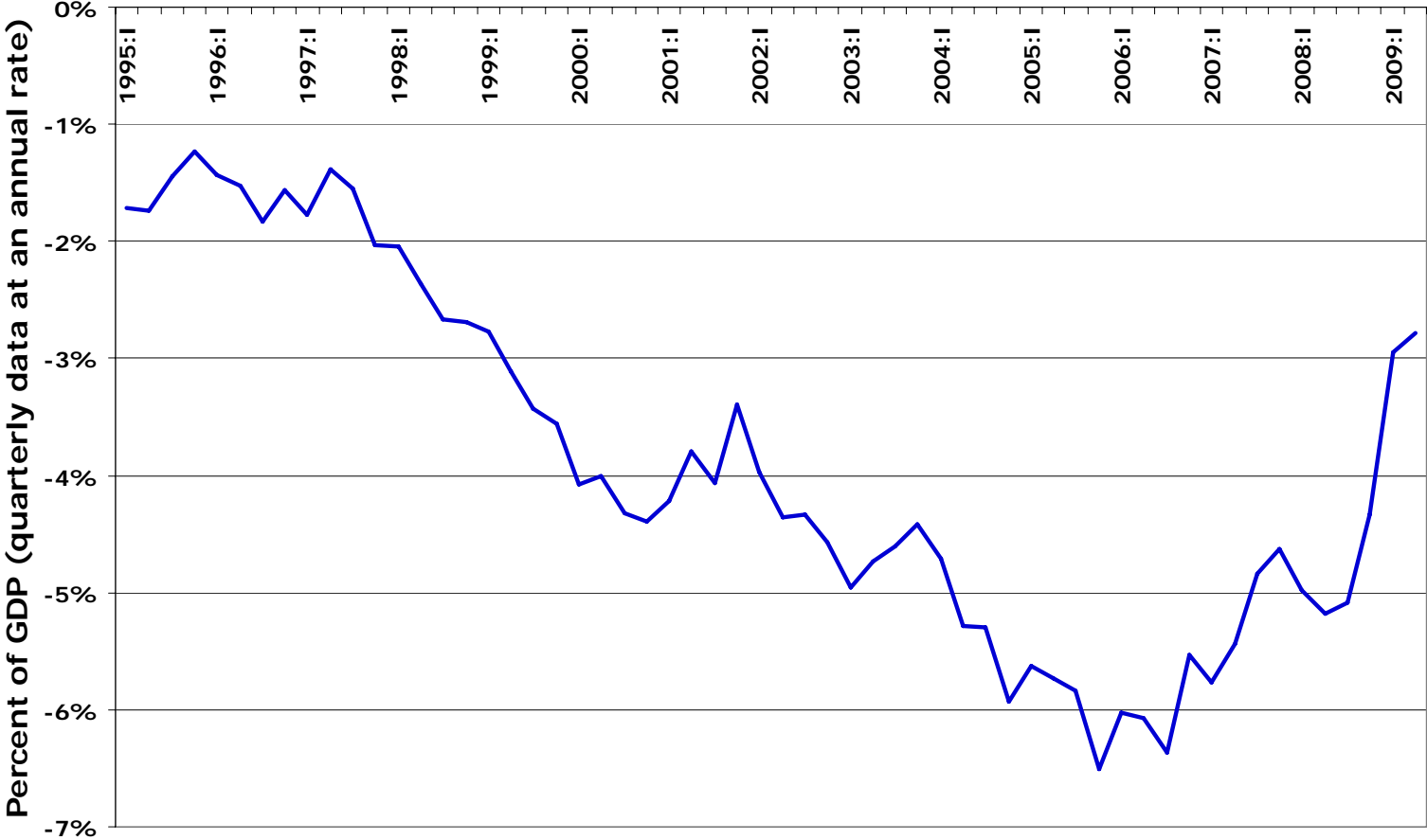
- I. Global CA imbalances: some basics
- II. Why worry: good vs. bad imbalances
- III. Reducing CA imbalances: national perspective
- IV. Reducing CA imbalances: global perspectives
- V. Some lessons for policy coordination and IMF Surveillance

# I. Global imbalances: some basics

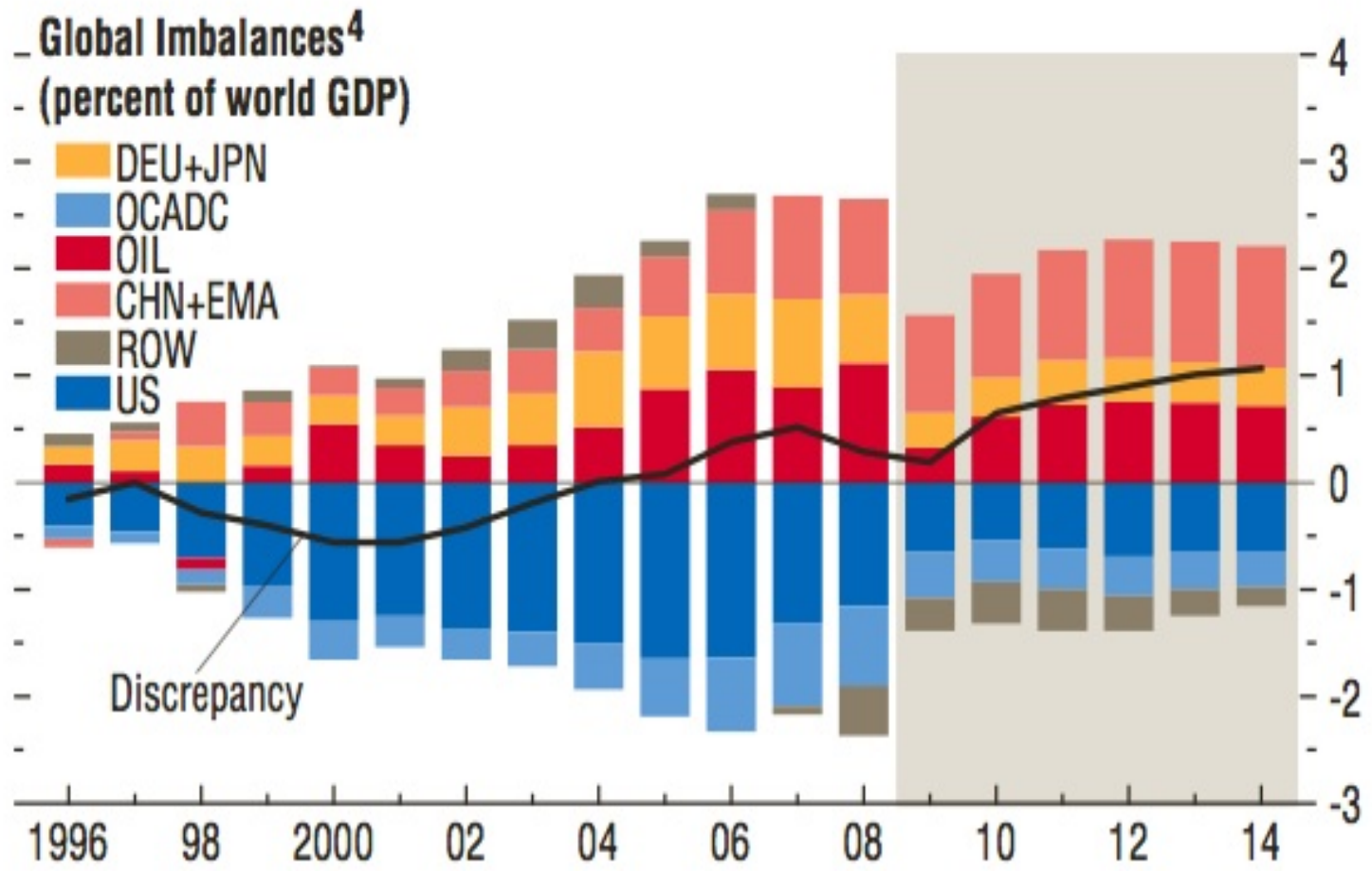
- ❑ Imbalances, weasel words and jargon
- ❑ **By global imbalances we will mean here:**  
large (in % of world GDP) and persistent **current account** deficits (and matching surpluses in the rest of the world) affecting one country or a group of countries over time
- ❑ Current account imbalances. Basic:  
$$CA = Y - E = \text{Nat.Saving} - \text{Nat.Investment}$$
- ❑ Obvious lesson: if want to change CA, you have to change E relative to Y
- ❑ The rising U.S. current account deficit over the past fifteen or twenty years is of course the current case in point. The U.S. deficit of the 1980's was a similar instance of popular concern

# US Current Account/GDP ratio

— CA/GDP ratio



Source: BEA



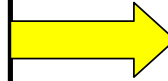
Source: IMF, WEO

## II. Why worry: Good vs. bad imbalances

- Obviously not every imbalance is worrisome
- **Good imbalances:**
  - Reflect private decisions (inter-temporal in the case of CA surplus and deficits) in the absence of externalities and distortions
  - Corresponding capital flows should allow preferences of lenders and borrowers to be reconciled, capital to flow from where it is abundant to where it is scarce, portfolios to be better diversified, and shocks to be insured against
  - One way to look at **sustained** imbalances is through the lens of the stages of the balance of payments hypothesis

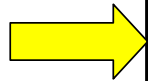
### Stage I: Young debtor

- Trade deficit
- Net outflow of interest payments
- Net capital inflow
- Rising debt



### Stage II: Mature debtor

- Decreasing trade deficit, beginning of a surplus
- Net outflow of interest payments
- Decreasing net capital inflow
- Debt rising at diminishing rate



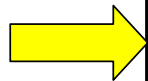
### Stage III: Debt reducer

- Rising trade surplus
- Diminishing net outflow of interest payments
- Net capital outflow
- Falling net foreign debt



### Stage IV: Young creditor

- Decreasing trade surplus, then deficit
- Net outflow of interest payments, then inflow
- Outflow of capital at decreasing rate
- Net accumulation of foreign assets



### Stage V: Mature creditor

- Trade deficit
- Net inflow of interest payments
- Diminishing net capital flows
- Slow-growing or constant net foreign asset position

Adapted from World Bank,  
World Development  
Report, 1985

- **Bad imbalances:**

- Example: CA surplus reflecting distortionary taxes on consumption (China?); CA deficit reflecting “excessive” government deficit (U.S. twin deficits?)
- Of course a bad imbalance in the eyes of one observer may be a good one in the eyes of another.
- Bad imbalances may be unsustainable; since they won’t be sustained, why worry?
- Reflect distortions, externalities, or inappropriate policy somewhere else in the economy



- Why contemporary CA pattern may reflect “bad imbalances”:
  - Uphill flow of capital
  - Reflect distortions in national policies
    - Chinese surplus partly reflects distortive taxes on consumption/ US. Deficit partly reflects excessive govt. deficit
  - Creating externalities (e.g. instability)
  - Savings glut vs. fiscal profligacy
  - Bretton Woods II: the benign thesis
  - Unsustainability and a violent unwinding: the catastrophe scenario

- **The current account: target or indicator?**

- First task: try to determine an appropriate or optimal level of and/or path for the CA (an enormously difficult task).
- If that level or path is different from the current value of CA, ask what kind of distortion/imbalance elsewhere this reflects.
- A discrepancy between the current and “optimal” value of the CA can thus be interpreted as an *indicator* of something wrong elsewhere.
- Whether this discrepancy itself should also be a *target* of policy is doubtful although it could serve as an indicator of the effects of policies when the latter are addressed at the root problem which the discrepancy signals.
- In any event, to affect the current account, policy must affect the balance between national saving and investment. More on how this can be done and the problems that arise under the next headings.

### III. Reducing CA imbalances: national perspective

- Suppose, for whatever reason, a country wants to reduce an “excessive” CA deficit or surplus. What policies should it undertake? Obviously, since CA is the difference between national saving and investment, or between national income and domestic expenditure, policies affecting S and I are of the essence.
- So surplus countries should undertake expenditure expanding measures, deficit countries expenditure contracting measures.
- The principle of attacking distortions at source suggests that fiscal policy is the expenditure-changing instrument of choice.
- This holds irrespective of the exchange rate regime (cf. extensions of the Mundell-Fleming model)
- But conflicts between targets (e.g. internal and external balance) may arise in a multiple target setting.
  - ✓ Solution: monetary/ fiscal assignment à la Mundell. Fiscal policy retains a comparative advantage for reaching CA target. Not panacea of course.

## **IV. Reducing CA imbalances: global perspectives**

- At the IMS level, much more difficult since:
  - “Shared variables” involved: one country’s deficit is the ROW’s surplus, one currency’s depreciation is another’s appreciation.
  - Must at least agree that imbalances are currently too large and should therefore be reduced.
  - One set of rules for achieving CA rebalancing is the classic “sharing the burden of adjustment rules” .....but they break down in policy conflict cases.
  - International policy coordination would seem to be the solution.

- From cosmopolitan, global, point of view in an integrated world economy policy should/could (to oversimplify):
  - Maintain world demand at level of world potential output
  - Make sure actual can match potential output: remove bottlenecks and distortions on supply side
  - Distribute world demand so as to ensure CA sustainability, if not optimality
- But how do you do it ?
  - For CA, use relative fiscal stances (F/FROW)
  - For world demand use sum of national fiscal stances
  - Use national structural policies to alleviate supply side bottlenecks and distortions
- This raises obvious coordination problems

## Why is coordination so difficult?

Obstacles to policy coordination (in addition to uncertainty about the static and dynamic structure of the economy):

- What makes coordination necessary, namely a high degree of economic integration, also makes it difficult with a fragmentation of policy making among sovereign states
- Inconsistent goals
- Requires changes to what appear as fundamentally domestic choices
- Shortage of instruments or reluctance to use them leading to tradeoffs that are politically painful and tend to be avoided
- Procrastination: there is never a good time for reform
- First mover problem

- Can quantitative norms help the coordination problem with respect to current account rebalancing?
  - Geithner 4% of GDP limits on CA deficits and surpluses:
    - If anything should be stated in % of world GDP
    - 4% is arbitrary
    - Does not deal with optimality question
  - Again better to think of CA “imbalances” as indicators of policy and not targets
  - Here the G-20 / MAP approach is analytically more correct but it does not have much of an impact for all the reasons mentioned when describing difficulties of policy coordination.

## **V. Some lessons for policy coordination and IMF surveillance**

1. Target welfare relevant variables such as output, inflation, growth, consumption, not endogenous variables such as CA or RER.
2. Formulate diagnostics and recommendations in terms of policy actions and not outcomes.
3. Make the norm by which or the reasons for which an actual CA deficit or surplus is judged to represent an “imbalance” or an indicator of such “imbalance” explicit.
4. If worried about impact of imbalances on world economy, look at them relative to some world aggregates such as world GDP or world bond market capitalization, etc.



5. Shift emphasis from exchange-rate policy (whatever that may mean) and the exchange rate (an endogenous variable) to macroeconomic policies and their consistency with each other and with the exchange-rate **regime**.
6. The IMF/G-20's MAP approach to policy coordination is analytically a move in the right direction as it seeks to evaluate the impact of specific policy actions on welfare relevant variables. It could potentially help solve the first mover problem, de-emphasizes CA imbalances to some extent and does not forget other issues (or "imbalances"). How difficult the policy coordination exercise is in practice, however, is revealed by the wrangling around and the vapid outcome of the G-20 finance ministers' recent Paris meeting.
7. At this stage it is best to look for simple policy packages that emphasize moving policy instruments in the right direction and consistently rather than more ambitious fine tuning schemes that set specific numerical values for policies.

8. This is not to deny that rules policy coordination would be highly desirable. But such rules should be broad rules of behavior that insure adjustment in the right direction and are consistent with both the exchange-rate regime and system stability. One relevant example is the rule: if you wish to run a fixed exchange-rate system you ought not to sterilize international reserve flows completely and for a substantial period of time.