Other articles

THE INTERNATIONAL CURRENT ACCOUNT IMBALANCES: A SCEPTICAL VIEW

W. Max Corden

The international current account imbalances, whereby the USA has a vast deficit and several countries, notably Japan, China, Germany and the oil exporters, have corresponding surpluses, are usually seen as problems. The argument here is that current account imbalances simply indicate intertemporal trade – the exchange of goods and services for financial claims. There are as likely to be gains from trade of that kind as from ordinary trade.

Intertemporal trade

A country that is running a current account deficit is selling financial claims of various kinds – bonds, equities and so on – in exchange for buying goods and services. Let me simplify by using the term 'bonds' for claims of all kinds, and 'goods' for goods and services of all kinds. It is selling bonds and buying goods. The bonds entitle the buyers to 'goods tomorrow'. Similarly a country with a current account surplus is selling goods and buying bonds. This is 'intertemporal trade' – the exchange of goods today for goods tomorrow. For example, on average, Chinese citizens sell more goods to the USA than they buy from the USA but they buy more US bonds than US citizens buy Chinese bonds. Those bonds entitle holders to a series of returns that will enable them to buy US goods in the future. A country normally engages in three kinds of trade, namely trade in goods (and services), which is analysed in standard trade theory, trade in claims of all kinds – that is capital market trade designed often to achieve portfolio balance, and this is also likely to involve an intertemporal element, and finally trade in financial assets in exchange for goods and services, which I call intertemporal trade here.

The big question

Why should an increase in the quantity of intertemporal trade be a problem? An increase in the current account deficit of the USA matched by increases in the current account surpluses of various other countries, notably Japan and China, is certainly perceived as a problem in various international discussions and an extensive literature. Presumably there are gains from trade of this form as there are from any other form of trade. Furthermore, it is not at all surprising that globalisation – above all, increased international capital mobility – has increased this type of trade. We know that even free trade can lead to problems, so that there may be something to investigate. My suggestion is that we should follow the approach usually practised in trade theory, and start with the presumption of the optimality of free trade, based on the theory of comparative advantage. Hence a high level of intertemporal trade reflected in a high level of 'current account imbalances' may simply be one of the fruits of globalisation. Using the argument of the optimality of free trade as a starting point one then looks for explicit qualifications, carefully analysing them. Perhaps the increase in trade is based on unwise decisions by various buyers and sellers (from the points of view of their own interests), or it is likely to be temporary (that is, it is not 'sustainable'), and a reversal may involve costly adjustment problems.

How does the system equilibrate?

The market for intertemporal trade depends – just like any market – on highly decentralised decision-making. There are many countries that have current account surpluses and quite a few that have deficits, though in recent years the USA has been by far the dominant deficit country (see Table 1). Furthermore, governments do not actually have current account targets, or if they happen to have them they cannot directly determine whether they hit them. To some extent they can determine fiscal policy, which can be a big or even dominant influence on their countries' current accounts, but current accounts also depend on the savings and investment decisions of numerous private actors: both households and corporations.

How, then, does it come about that the world system equilibrates so that total surpluses are equal to total deficits? Of course, statistically there is a gap. It seems as if the world is always in deficit (to Mars?), but that just reflects inevitable statistical errors. In principle, as in any free market, in equilibrium desired supply must equal desired demand. The answer, of course, is that price movements equilibrate markets. In this case it is the world real interest rate, which moves inversely with the price of bonds in terms of goods. One can tell the following kind of 'stylised' story. Firstly, there are *exogenous* changes, equivalent to shifts in the demand and supply curves. An example of an exogenous change is the US fiscal expansion from 2000 explained by political factors, such as the ascent of tax-cutting ideology. Another one is the decline in investment in Japan, which is explained by the earlier excesses of an investment boom. These exogenous changes cause the price (in this case the real interest rate) to move, and this, in turn, brings about movements along supply and demand curves until the system is in equilibrium. These latter changes resulting from movements along the curves are *endogenous* changes.

Examples of endogenous changes are the housing booms in various countries, such as the USA, Spain, the UK and Australia, which can be explained – at least to some extent – by the decline in the world real interest rate. The increased wealth resulting from the housing booms has led to higher private consumption. We observe in the statistics the effects of a combination of exogenous and endogenous changes. What has happened in this particular intertemporal world market since 2000 is that the supply curve of bonds shifted to the right less than the demand curve, so that the world price of bonds (representing, in my simplified exposition, all financial claims) rose – i.e. the world real interest rate fell.

Table 1: Current account imbalances 2005[1] (billions of US dollars)

Current Account Deficit Countries		
United States		–805.0
Three Developed Deficit Countries		–186.2
Spain	–85.9	
UK	–58.1	
Australia	–42.2	
Central and Eastern Europe*		–63.1
Current Account Surplus Countries		
Fuel Exporters*		347.4
Middle East*	196.0	
Russia	86.6	
Norway	49.7	
Japan		163.9
China		158.6
Germany		114.8
Switzerland		50.7
Netherlands		40.0
NICs[2]*		85.6

[1]All countries with a deficit or surplus of $40 billion or more are listed, except for groups (marked *) which also contain smaller imbalance countries.
[2]NICs: Newly Industrialised Countries – Singapore ($33.6 billion), Hong Kong SAR ($19.0 billion), Korea ($16.6 billion) and Taiwan PoC ($16.4 billion).
Source: IMF, *World Economic Outlook*, April 2006.

Why the big surpluses?

So far I have just set the stage for the main story. Next, one must look in some detail at what has actually happened in various countries. Have the policies and the private sector decisions been desirable in some sense? Have they been rational? One has to look at the public policies and the private motives that explain the surpluses and deficits. That will give some insight as to whether the imbalances are likely to be reduced by decentralised decision-making and, if not, whether some international pressure should be exerted to bring about reductions.

Every country has its own story, but it is certainly not difficult to show that, on the whole, decision-making has been reasonably rational. The Japanese ageing population has maintained a high savings rate for obvious demographic reasons, and one would expect that to be eventually reversed. Japan and some other Asian countries have had high investment ratios relative to GDP compared with the USA and European countries, but these ratios have declined owing to earlier over-investment. In particular, in various East Asian countries there was a massive construction boom which suddenly – and understandably – came to an end with the Asian crisis. Some countries have deliberately built up foreign exchange reserves in reaction to the embarrassment in the Asian crisis of dependence on IMF rescues.

The most interesting case is that of China. On the basis of the figures available, savings have been about 50% of GDP whilst investment has been about 45%, yielding a current account surplus of about 5%. The latest 2005 figure is actually 7%, and the main point is that both the savings ratio and the investment ratio are extraordinarily high by the standards of other countries. Should China save less? Presumably high household savings are explained by demography, by the absence of social security, and by the need to save for children's education, while high savings of firms are probably a temporary by-product of the high growth rate. As for investment, there has been a massive investment boom.

Whilst one can understand high private savings, it is hard to justify high public savings (whether by the government itself or by government-owned companies), other than as a very temporary phenomenon. But it is not hard to justify sending a significant part of savings (about 14% in 2005) abroad – again temporarily. It seems perfectly rational to invest some of the extra savings abroad given the inefficiency so far of the financial system in allocating funds – as reflected in the high volume of non-performing loans held by the banks. The public sector also, has yet to improve the efficiency of public investment. Thus it seems reasonable to 'park' a proportion of funds abroad until efficiency in domestic investment allocation improves. This is the 'parking theory'. And that implies a large current account surplus. Some of these funds might eventually be used to pay off non-performing loans, as well as to increase investment at home even further once efficiency has improved. Perhaps the savings ratio will also decline.

Finally, it is inevitable that the increased oil price has raised the savings of the oil exporters, notably Russia and Saudi Arabia. On past experience this will be a temporary phenomenon. One would surely not want the oil exporters immediately to increase domestic consumption or investment so as to avoid current account surpluses.

Why the big deficits?

The deficits in total have to be equal to the surpluses, with endogenous changes bringing this about. I have already referred to endogenous changes consisting of housing and private consumption booms in a number of countries, notably the USA, the UK, Spain and Australia. These reactions, leading to significant current account deficits of these countries, can also be regarded as rational. The fact that the market generates an equilibrating mechanism simply demonstrates the virtue of the market.

But there do remain two connected questions. The first is the role of the US fiscal deficit from 2000, resulting from tax cuts combined with increases in military and homeland security expenditures. Has that been exogenous or endogenous? The second question is why the decline in the world real interest rate has not led to increases in private investment (other than in housing) in countries outside the USA. In other words, why has the USA been overwhelmingly the principal deficit country? The low growth rates and poor prospects of major European countries, including prospective population declines and failures to bring about necessary structural reforms, must have played a part in the answer. The two developed countries that have large surpluses are Japan and Germany (see Table 1). In both cases the population is rapidly ageing. On the one hand this has raised their saving propensities, but on the other hand the prospective decline in the working population of young age has reduced the expected return on capital (capital and labour being complementary), and hence has reduced domestic investment. Thus their current account surpluses are easily explained.

The Keynesian complication and US fiscal policy

There is an important qualification to the argument that the world intertemporal market is equilibrated by the world real interest rate. Let us suppose for a moment that the exogenous increases in net savings (resulting from changes in gross saving, in investment and in fiscal policies) had indeed taken place in Asian and other countries as they actually did happen. But, to start with, there was no movement into fiscal deficit in the USA as Mr Gore had become President; there had been no tax cuts and no Iraq war. In that case the world real interest rate would have fallen even further than it actually has fallen. Possibly it might have fallen to zero. With a modest degree of inflation – which I assume would have continued – it might even have been moderately negative. But the real interest rate could not go lower unless inflationary expectations were generated since nominal interest rates cannot be less than zero.

Monetary policy would become impotent in maintaining aggregate demand. The world would have been in a situation similar to that of Japan in the 1990s (sometimes described as a 'liquidity trap'). This would have been a 'Keynesian situation'. Excess savings (and hence the surpluses of the surplus countries) would have been reduced through falls in real income.

With nominal interest rates very low, and possibly zero, governments not just in the USA but also elsewhere would probably have chosen to go into deficit not only because of the automatic stabilisers but also for Keynesian stabilisation reasons. Thus there would still have been a US fiscal expansion, brought about by tax cuts or expenditure increases, or both, though possibly not as big as has actually taken place under the Bush administration. It would have been *endogenous* rather than *exogenous*. Some other countries might have shared the task. An important limit to this sharing would have been the Stability and Growth Pact of the eurozone countries.

One could also turn this analysis of the recent past around. This time, suppose that there had indeed been the US fiscal expansion resulting from tax cuts and the Iraq war, but that there had not been the increase in savings in China and the declines in investment in various countries, notably Japan. Nor had there been a new oil shock. In other words, suppose that there had not been the large increase in the excess of savings over investment, private and public (the 'savings glut') coming from the countries that have actually turned out to be the surplus countries. In that case real interest rates in the USA and the world would have risen, possibly severely – the cause having been the US fiscal deficit. There might have been no housing booms in various countries, including the USA, but the US fiscal expansion would have imposed a greater burden on the future US taxpayers through its effect in raising the interest rate. And there would have been popular complaints about high interest rates. The political pressure to moderate the fiscal expansion would have been powerful. The Bush administration should thus be grateful for the high savings, relative to investment, in Japan, China and elsewhere which actually did take place and which thus avoided an increase in real interest rates. In fact, there have been gains from this kind of intertemporal trade just as from 'ordinary' trade in goods and services. The gains have been to the US administration and to the current US taxpayers, though not to the future taxpayers.

Those 'unsustainable' imbalances: two scenarios

It is widely argued that the imbalances cannot go on, and it will all end in a crisis or a 'disorderly adjustment'. The longer the imbalances go on, and thus the more the debt of the debtor countries builds up, the bigger will be the eventual crisis – and, of course, the biggest debtor country is the USA, so that any crisis will revolve around the USA and the dollar. Above all, the issue then appears to be: can the USA (and especially the US government) continue to go into debt at the present rate? There are several scenarios one can imagine. Here I just discuss two of them, though there are other reasonable ones.[1]

In the first scenario the world real interest rate rises. This would happen if the savings glut of the surplus countries declined, without initially an associated reduction in the US fiscal deficit nor an ending of the boom in US private sector borrowing. It is indeed quite likely that within a few years the surpluses of some of the surplus countries, notably China and the oil exporters, will decline. Furthermore, there are various emerging market countries where the demand for funds by the private sector may well rise significantly and that could even strengthen the tendency for the world real interest rate to rise. In this case the current account deficits of the USA and other countries would be naturally reduced by higher interest rates: US private sector spending for consumption and investment would decline owing to the higher cost of borrowing. Furthermore, a US administration and Congress would soon decide that they must cut spending and raise taxes. Lenders will gain and borrowers – including the US taxpayer, present or future – will lose. Housing booms will come to an end (if they had not before that). There will be political difficulties.

In addition, the dollar is likely to decline. Since the surplus funds of the surplus countries have been overwhelmingly invested in the USA the demand for dollars relative to other currencies would certainly decline, and this would depreciate the dollar.

In the second scenario the world real interest rate falls, so this is the exact opposite of the first scenario. This result would be brought about if the US fiscal deficit were significantly reduced and if US private sector spending fell owing to the ending of the housing boom, while the savings glut of many surplus countries continued. In that case the world real interest rate would decline and the possibility of a 'Keynesian situation' would arise. Monetary policies might become ineffective in maintaining employment. This is the case that would present the biggest problem. The dollar would again fall, so that for the USA there would be an offset to the deflationary effects of a fiscal contraction. Other countries – notably the eurozone countries – would need to have some fiscal flexibility. The low interest rates and ready availability of credit might create private sector booms. If these were not sufficient some countries at least would need to substitute to some extent their fiscal expansions for the fiscal contraction of the USA.

A dollar crisis?

Need there be a dollar 'crisis' or even a 'disruptive' one? The two scenarios (and some others) suggest that the dollar must eventually depreciate, possibly to a large extent. The question is whether such a depreciation must be sudden. Perhaps it could be gradual.

In the case of the first scenario an important point is that the surplus countries are so diverse, and are subject to a variety of influences, so that it is improbable that they would radically change their savings and investment behaviour at the same time. The answer presumably is that the depreciation may take place in advance of the actual declines in the savings glut if the latter are expected. And that is where common fears of an exchange rate crisis arise. Once the market realises that eventually international demand for US bonds and equities will fall owing to the decline in the savings glut – even though this decline is only expected to develop gradually – it may bring about a sudden and sharp depreciation.

Thus it all hinges on expectations. Expectations of a depreciation anticipate the fundamental changes. This would also apply to changes originating in the USA. Yet, here also, one can have doubts whether depreciation need be sudden. Given uncertainty about policy changes in various countries, including the USA, it is also possible that expectations change gradually, so that depreciation is gradual, as indeed it has been so far. A decline in the dollar will, of course, involve a mixture of favourable and unfavourable effects for various countries and sectors within countries.

Conclusion

To sum up, international current account imbalances are not necessarily undesirable even when they are large for the same reason that trade is not undesirable. That should be the starting point of any analysis. There are gains from intertemporal trade. It is obvious, for example, in the case of the oil exporters that they should not necessarily increase either their domestic consumption or their investment sufficiently to avoid any increases in their current account surpluses. Even in the long run it may be wise for them to invest some of their savings abroad. From their own point of view they should invest wherever the expected returns are highest, allowing for risk and desired liquidity. Similarly, the Chinese are not necessarily irrational in having a high savings propensity when the growth rate is so high, and for other reasons, and in choosing to invest some of their savings abroad, at least temporarily. Households in various developed countries, including the USA, may also be rational in responding to low real interest rates and ready credit with spending booms.

In other words, what one observes in various countries may reflect reasonably rational behaviour. Close knowledge of each case may, of course, lead one to different conclusions. In any case the criterion of whether changes in private savings, investment or fiscal policy, would lead to reduced current account imbalances is not an adequate guide to whether the changes are desirable.

Yet there are four potential problems. These are not necessarily qualifications to the 'gains from trade' argument. But they may qualify the view that there is nothing to worry about.

The first is the 'Keynesian problem' which could arise if the savings glut continued or even intensified whilst US fiscal policy became significantly contractionary relative to its current level. For this eventuality fiscal policies not just in the USA, but also elsewhere, notably in Europe, should be flexible. The second potential problem, much emphasised in the literature, is that the value of the dollar might fall sharply in expectation of the likelihood of a reversal of the current situation. A sharp sudden fall in the dollar could have a variety of adverse effects outweighing its favourable effects. Sudden changes in whatever direction usually create problems somewhere, though it is certainly not inevitable that a decline in the dollar would be sudden and disruptive. The third possible problem (the opposite of the first) is that the savings glut may in due course contract, causing world interest rates to rise and so leading to housing market or stock market crashes, and, more generally, to difficulties for borrowers, and especially the US government.

These are all potential short- or medium-term effects. A fourth problem, which is essentially a long-run problem, is that some big borrowers, notably the US government as well as some private borrowers, may eventually find it difficult to meet their debt service obligations. This relates to two issues: firstly, whether investment in the USA is adequate, and secondly, whether the US political system is capable of increasing tax rates required to fulfil various future obligations.

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1. These are discussed in the article in *The World Economy*.

Max Corden is Professorial Fellow at the University of Melbourne and Emeritus Professor of International Economics of the Johns Hopkins University (wmcorden@iinet.net.au).