

Global imbalances: current accounts and financial flows

Stephen G Cecchetti*

Economic Adviser and Head of the Monetary and Economic Department
Bank for International Settlements

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It is an honour and a pleasure to speak this afternoon here at the University of Chicago. My topic today is cross-border flows. It is difficult to find anyone who would protest the increase in international trade. To give you some sense of the magnitude: in a span of 30 years, the global ratio of exports plus imports to GDP has risen from 43%, in 1980, to 59%, in 2010. Even in the United States, notoriously less open than other industrialised countries, the same measure rose from a much more modest 21% to a still relatively low 32%. The benefits we all reap from this are so easy to see that virtually no one seriously suggests reversing the tide. In fact, I would count the fact of so much more trade openness, as well as society's attitude towards it, as one of the great successes of the latter half of the 20th century. And, I consider the fact that the ugly spectre of protectionism has not raised its head during the last four crisis-ridden years as both a victory and a relief.

Accompanying the increase in trade flows is an increase in financial flows – capital moving across international borders. As is the case with goods and services, these financial flows come in a wide range of flavours. The big categories are foreign direct investment, such as the acquisition and construction of buildings, and portfolio flows, including the purchase of equity and bonds along with interbank loans. When considering cross-border financial flows, it is important to distinguish net from gross. The first of these are related to the global imbalances as commonly construed – the large and persistent current account surpluses and deficits. And, the absolute sum of surpluses plus deficits was around 2% of world GDP in 1980, more than 6% of world GDP at their peak in 2006, and over 4% of world GDP today. Since current account imbalances are matched by equal and opposite capital account imbalances, this means that there is a very large net capital flow – net flows of assets across borders.

But, unsurprisingly, these net flows are supported by much larger gross flows. The latter give rise to international investment positions – US investors buying Asian equities, and Asian investors buying US Treasury securities, to take one common example. Gross flows tend to be two to three times the size of the net flows. And the resulting balance sheets are huge – our estimate is that they are approaching \$100 trillion!

Like the trade flows I mentioned a moment ago, these gross financial flows have been growing. But more importantly, these are the source of the stresses in the international community today. Countries that run balanced current accounts (or close) still complain about capital inflows. But, since they are not experiencing *net* capital flows – a balanced current account means a balanced capital account – their complaint is about the gross flows.

As is the case with goods and service flows, I'm sure that you would all agree that international capital flows are a good thing. Well, since I'm at the University of Chicago, I assume that you do.

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History, even very recent history, is strewn with examples of governments attempting to restrict cross-border capital movements. My own view of capital controls is very much in line with the orthodoxy of the economics profession: they do more harm than good, often much more. Instead, I strongly believe that international capital flows, like their intra-national cousins, improve efficiency and welfare.

Returning to current account surpluses and deficits – the global imbalances that we have been discussing for so long – we can now see the consequences. Remember that a current account deficit means that a country is spending more than it is producing. Just like with an individual, when a country's spending exceeds its income, it must either borrow from abroad or sell foreigners something it owns. A current account deficit is matched by a capital account surplus. There is nothing wrong with this in principle. In the same way that borrowing can help a family to smooth consumption in the face of volatile income, current account movements can help a country smooth investment in the face of volatile saving. But, again using the family analogy, if borrowing becomes large and endemic, it creates a problem.

Put another way, the export-led growth in the surplus countries feeds the leverage-led growth in deficit countries. This symbiotic relationship is really an unhealthy co-dependency. It eventually leads to disaster. Stopping it means adjusting; but how?

Ensuring that imbalances in cross-border financial flows decline smoothly requires a combination of structural and price adjustment – in both deficit and surplus countries. Deficit countries need more domestic saving and surplus countries need more domestic consumption. We might agree that this would be right in the long run. However, speeding up such an adjustment in the short run is difficult, as the US is sputtering while China overheats.

A natural way to speed the adjustment is through prices. In this case, that means prices of imports would rise in the deficit country and fall in the surplus country (and the reverse for exports). There are three ways that this real exchange rate movement can occur: domestic prices can fall in the deficit country; domestic prices could rise in the surplus country; or the nominal exchange rate could move. Should we favour one of these over the others? Considering international balance sheets helps to clarify that nominal exchange rate flexibility is the crucial channel through which this adjustment should occur.

In the remainder of my remarks, I will go into slightly more detail on the current account, then discuss international balance sheets and finally describe the options that exist for adjustment. To restate my conclusion, given the desirability of maintaining monetary stability, adjustment will require that nominal exchange rate flexibility play a larger role in resolving global current account imbalances than it has thus far.

I. Global current account imbalances

I would like to start with Graph 1 and what I will call the traditional view. The bars stacked one on top of the other above the centre line are current account surpluses measured as a percentage of global GDP. You can see that China, Germany, Japan and the oil-exporting countries are running large and persistent current account surpluses. Below the centre line, there are current account deficits measured as a percentage of global GDP. You can see that the United States, Spain, Italy and the United Kingdom have run large and persistent current account deficits.

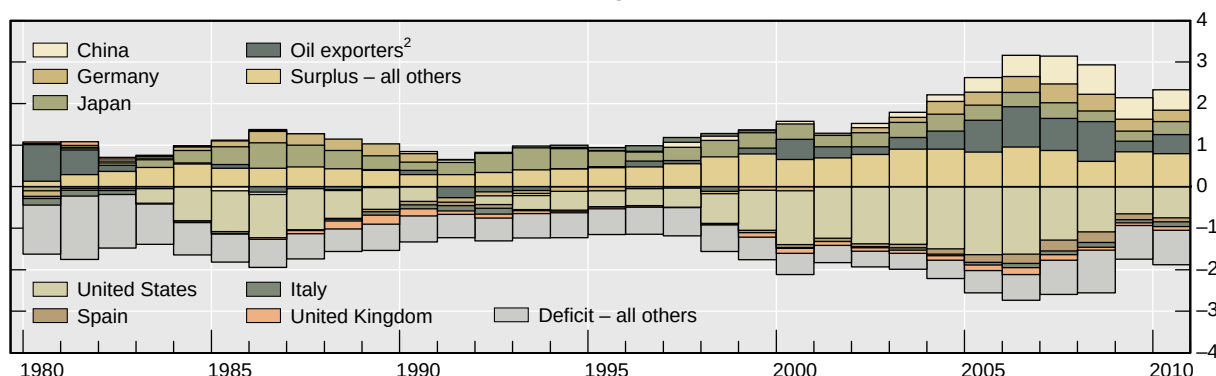
These imbalances carry risks. The most important is the risk of disorderly adjustment. Should financial flows funding the current account deficits reverse suddenly, the result could be a large exchange rate move with potentially global ramifications. Furthermore, countries may struggle to efficiently absorb the capital inflows financing the deficits. Finally, there is always the possibility that trade imbalances will prompt deficit countries to turn to protectionist measures.

Simply looking at this graph makes clear why people are worried: the bars have grown enormously. As I noted in the introduction: before the financial crisis, the sum of surpluses and deficits had risen to more than 6% of global GDP. To put this into historical perspective, I will

simply note that the hardly visible bump in the mid-1980s prompted global leaders to adopt the Plaza and Louvre Accords for coordinated exchange rate action.

To see how we might change this, it is useful to think about net exports (exports minus imports) and net saving (domestic saving minus domestic investment) separately. Deficit countries need a combination of higher net exports and higher net saving, while surplus countries need the opposite. Deficit countries need to break their addiction to debt, and surplus countries need to wean themselves away from their dependence on exports.

Graph 1
Global current account balances¹
As a percentage of world GDP



¹ Data for 2010 are IMF estimates. ² Algeria, Angola, Azerbaijan, Bahrain, Brunei, the Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Iraq, Kazakhstan, Kuwait, Libya, Nigeria, Oman, Qatar, Russia, Saudi Arabia, Sudan, Syria, Trinidad and Tobago, Turkmenistan, the United Arab Emirates, Venezuela and Yemen.

Source: IMF, *World Economic Outlook*.

Unfortunately, such adjustments quickly run up against significant short-run obstacles. Most surplus emerging economies are overheating: growth is strong, inflation rising and property markets booming. Policies designed to stimulate domestic consumption could simply exacerbate existing inflationary pressures in consumer and asset prices. Conversely, many deficit advanced economies are experiencing weak growth. Pressing for lower consumption and higher saving at this point could force further slowing and risk another unwelcome drop in inflation.

That said, there are clearly useful structural measures that could and should be put into place. For example, deficit country governments that have in place tax preferences for borrowing over saving should reflect on their benefits. And surplus countries that are subsidising exports might reconsider their choices. But as desirable as these and other changes might be, they are likely to be relatively slow.

This brings us to the real exchange rate. Economics and experience teach us that when demand exceeds supply, prices rise. If the relative price of a current account deficit country's exports were to fall, two things would happen. First, sales abroad would rise, so exports would increase. And second, domestic consumers would switch to domestically produced alternatives, driving imports down. In sum, the current account deficit decreases when the real exchange rate depreciates. And, similarly, if the real exchange rate appreciates, the current account surplus decreases.

Given the centrality of real exchange rates to the argument, let me add some detail. When we look at exchange rates, in tourist bureaus, company treasuries and dealing rooms, we see the nominal exchange rate. The nominal exchange rate is the value of one unit of a country's currency in terms of another country's currency. The real exchange rate is the rate at which you can exchange the goods of one country for goods of another country. It is the cost of a basket of goods in one country relative to the cost of the same basket of goods in another country.

That's pretty abstract, so I will make my point using the example of the Big Mac. In the United States, a Big Mac costs about \$4. In Korea, the same combination of two all-beef patties, special sauce, lettuce, cheese, pickles and onions in a sesame seed bun costs 3,700 won. At the current nominal exchange rate of 1,050 won per US dollar, a Big Mac in Korea costs the equivalent of

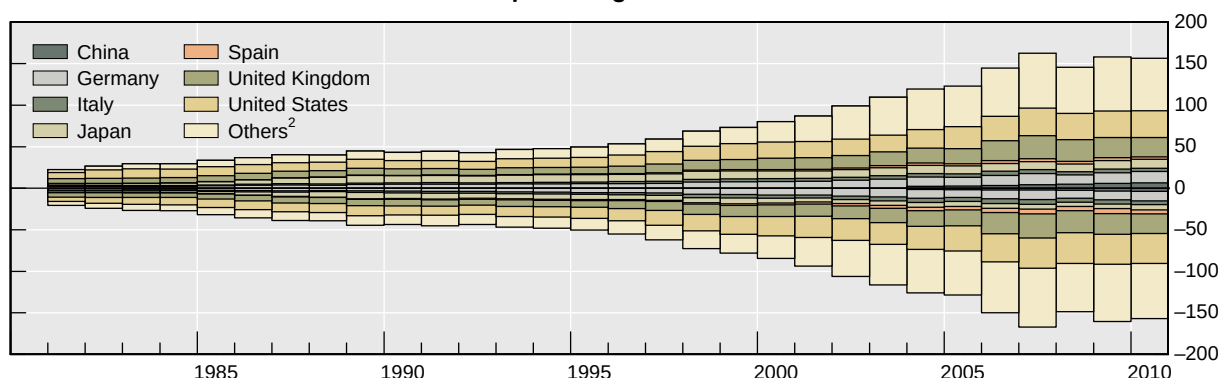
\$3.50. That's \$4 versus \$3.50. There are three ways to close this gap: (1) the price of the Big Mac in the US could fall to \$3.50; (2) the price of the Big Mac in Korea could rise to $4 \times 1,050 = 4,200$ won; or (3) the price of 1 US dollar could fall to $3,700/4 = 925$ won. Any combination of deflation in the US, inflation in Korea and an appreciation of the won would do the trick. Should we prefer one of these over the other two?

Before moving on, it is worth noting that the sensitivity of a country's current account to its real exchange rate depends on the composition of its trade flows. As Kharroubi (2011) discusses, the more a country's exports and imports are substitutes, the higher the sensitivity. And, conversely, the more exports and imports are complements, the less is the sensitivity. This suggests that the adjustment in the US deficit would be more responsive to changes in the US dollar real exchange rate than the adjustment of the Chinese surplus to changes in the renminbi real exchange rate.

II. International balance sheets

Let me now turn to international balance sheets and Graph 2. Above the centre line in the graph, you see assets, and below are liabilities, all as a percentage of global GDP. Assets are defined as foreign holdings of country residents. Liabilities are domestic assets held by foreigners in a country. Notice the increase from 50% to 150% of GDP over a period of roughly 15 years. In absolute dollar terms, the rise is even more dramatic: from \$15 trillion to nearly \$100 trillion.

Graph 2
International investment positions of all countries¹
As a percentage of world GDP



¹ Latest available data. ² Sum of 114 economies.

Sources: IMF, *International Financial Statistics* and *World Economic Outlook*.

The message here is that financial globalisation has been even more profound than trade globalisation. International balance sheet growth has far outpaced economic growth. I'm tempted to say that we are looking at the reaction of investors to two related puzzles – home bias in investing and the high correlation between domestic saving and domestic investment – by behaving as economic theory predicts. But that would be giving a bit too much credit to my profession.

The accumulation of cross-border assets measured in Graph 2 is the consequence of gross financial flows. Gross outflows create financial assets for residents of the country while gross inflows from abroad create financial liabilities. While gross financial outflows exceed inflows for current account surplus countries (and the reverse is true for deficit countries), these gross flows can be much larger than current account balances – and gross flows are not necessarily linked to net flows.

It is relatively easy to find examples where gross financial flows are unrelated to current account imbalances. Here are three that come to mind immediately. Pension funds diversify their assets internationally irrespective of the underlying current account balance. Of course, US pension funds

buy assets abroad even when the current account is in deficit. Similarly, firms do not make their international acquisitions and investments dependent on the current account position of their home country. Finally, even though current account imbalances between Europe and the United States were relatively small, Continental European banks did manage to acquire substantial quantities of mortgage-backed securities and US Treasury securities before the financial crisis. These assets were financed by, among other things, US money market funds.¹

Gross financial flows give rise to some of the same risks posed by net flows. They can stop suddenly, or even reverse. They can overwhelm weak or weakly regulated financial systems. And they can feed credit booms even in the absence of domestic credit growth.² It is, in fact, gross inflows that a financial system needs to be able to absorb and intermediate, not the net flows.

To see why I am concerned, consider a world composed of three banks in three countries. Bank A in country 1 lends to Bank B in country 2, which in turn lends to Bank C in country 3. Bank C in country 3 lends back to Bank A in country 1. Now, as things progress, the banks do ever more business with each other, and their balance sheets grow. The gross bilateral flows are big, and the net flows are non-existent. What matters is that the balance sheets get big and, because of the interconnectedness, if something goes wrong in one of the banks, the whole system can blow up. If one of the banks runs into trouble, so will the other two.

My point is that the large international balances in Graph 2 can create risks. If a problem arises in one place – in one country or jurisdiction – because of misallocations or mispricing, the interconnections can cause it to move through the system. And, as is the case with finance, what starts as a ripple can quickly grow into a tidal wave.

What can we do to address these risks?

One possibility, the wrong one, would be to turn back the clock on financial globalisation and get rid of these large international balance sheets. That would surely do it. But that would be like banning cars to stop traffic accidents.

The more thoughtful response is that we need monetary, fiscal and regulatory policies that provide the foundations for stability. Central bankers must maintain monetary stability, at the same time as they work to reduce boom-bust cycles. Fiscal policies must be put on sustainable trajectories that avoid even the possibility of sovereign debt crises. And regulatory policy must focus on systemic risk, reducing both the frequency and the severity of financial disaster.

Given the centrality of monetary stability to my argument, let me elaborate on it a bit further. Management of these large assets and liabilities is allocated based on price signals. Monetary instability distorts these price signals, which in turn distort asset allocation. Furthermore, the wealth transfers between creditors and debtors caused by things like inflation or deflation are a function of the size of balance sheets. Inflation hurts creditors, while deflation hurts debtors. I would argue that, given the size of international (and domestic) balance sheets, monetary stability is more important than ever.

III. Conclusion

Returning to where I started, current account deficits are large and rising. Global imbalances remain. But imbalances of this size cannot and will not be with us forever. The risk is that the adjustments will be disorderly. Surplus countries, and their investors, could suddenly decide that they no longer want to finance new borrowing by deficit countries. Or, even worse than merely stopping, they could quickly repatriate their foreign investments. The result would be intense pressure on nominal exchange rates.

¹ For a more detailed discussion of the issues associated with gross financial flows, see Kroszner (2008) and Bernanke et al (2011).

² See Borio et al (2011) for a discussion.

But real exchange rates do need to adjust. I would rule out deflation in the deficit countries. Not only would this have a catastrophic impact on the domestic economy where it is occurring, it would also make it even more difficult to repay the loans made by foreigners. Inflation in the surplus countries is not a good option for all the reasons that we know. It degrades the quality of price signals, leading to inefficient allocation of resources. And, in the cases where these are emerging market countries, inflation can create social tensions, as it has a disproportionate impact on the poor. Perhaps most importantly, high inflation – like a wildfire – is easy to start, but very hard to control once started.

This leaves us with nominal exchange rates and structural adjustments. From this perspective, the weakness in the US dollar contributes to the adjustment. And structural policies, as necessary as they are, will not work quickly enough. If we are going to continue to reap the benefits of substantial global trade and global finance, the world needs to move to reduce the large and persistent current account imbalances that have now been with us for too long.

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