Ian J Macfarlane: Payment imbalances

Presentation by Mr Ian J Macfarlane, Governor of the Reserve Bank of Australia, to the Chinese Academy of Social Sciences, Beijing, 12 May 2005.

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My talk today is about payments imbalances in the world economy, a subject that has received exhaustive attention over recent years. The reason for this is simple: it is not just that there are large imbalances between deficit and surplus countries, but that the pattern seems to have become entrenched over recent years. Table 1 below summarises the results for the past five years.

Most of the discussion has centred around the sustainability of the deficits, especially the deficit of the United States. Not surprisingly, the United States Government is then urged to adopt policies to reduce its deficit, and other countries are also encouraged to adjust their policies with the aim of reducing the US current account deficit. The US Administration has become quite vocal on this subject, but it is not clear that its outspokenness is helping to resolve the issue. I find this approach of starting with the US current account deficit not to be very constructive for several reasons which I will outline in this talk.

Table 1: Current Account

Per cent of GDP

	Japan	China	Other east Asia	Euro area	United States	Other
2000	2.5	1.9	4.7	-0.5	-4.2	0.8
2001	2.1	1.5	5	0.2	-3.8	0.4
2002	2.8	2.8	5.5	0.8	-4.5	0.5
2003	3.2	3.2	6.8	0.3	-4.8	1.3
2004	3.7	4.2	6.6	0.4	-5.7	1.6
Memo USD billion						
2004	171.8	70.0	123.7	35.6	-665.9	187.6

Source: IMF

Current versus capital deficits versus surpluses

A balance of payments account measures two separate concepts, each of which is the mirror image of the other:

- it identifies whether a country has absorbed more goods and services than it produced; and
- it identifies whether a country has lent to or invested more abroad than it has received from abroad.

The first is summarised by the current account and the second by the capital account; the two by definition have to add to zero. Attention is invariably concentrated on the current account rather than the capital account, and especially when the current account is in deficit. Why should we assume that the deficits are the problem? Why not assume that the surpluses are the problem?

I think the answer is that there is a belief that current account deficits are unsustainable, whereas surpluses could go on forever. This was a reasonable assumption for most of the post-war period, particularly under the Bretton Woods system, but may no longer be so. In a world of floating exchange rates and mobile international capital, the old rules may no longer apply. The discipline applied by the international market place on developed countries with current account deficits now may be very weak.

Even under earlier monetary regimes, there are examples of countries that have maintained current account deficits for long periods. The United States in the nineteenth century is a good example, as is

Australia in the twentieth. In the 1970s, Singapore ran a current account deficit which averaged 15 per cent for a decade. For developed countries with deep financial markets and little or no foreign currency exposure in their borrowing, current account deficits are not the problem they once were.

The United States has now run a current account deficit for fifteen years. During the first phase, it was predominantly financed by private investment and the US dollar strengthened. During the more recent phase, the gross inflows have still been private, but financing from foreign central banks has also been important and nearly matches the size of the current account deficit. Over the past four years, the US dollar has depreciated, but after fifteen years of cumulative deficits, the effective exchange rate of the US dollar is similar to what it was at the start of that period. The important point is that, despite widespread predictions to the contrary, it has not been difficult for the United States to finance its deficit.

So the scenario whereby world financial markets react to the US current account deficit by withdrawing funding has disappointed those who thought it would come into play. It may happen yet, but people have been predicting it for a long time and yet it seems no closer. A large part of the reason for this is that investors who want to get out of US dollars have to run up their holdings of another currency – they cannot get out of US dollars into nothing. They have to take the risks involved in holding some other currency, possibly at an historically high exchange rate, and they may well be reluctant to do so.

The other mechanism that could bring about a correction would be if the United States chose to implement policies aimed at reducing its current account deficit. This is not something that the Government would embrace quickly, as the population, by and large, is not complaining about the current situation whereby their consumption is subsidised by cheap loans from the rest of the world. Some of the appropriate policies may be worthwhile on other grounds, such as reducing the budget deficit, so I do not wish to argue against them. All I want to point out is that the usual policies which could reduce the current account deficit are not very appealing politically. In a world of floating exchange rates, all the policies available to the US Government involve reducing domestic demand, increasing national savings and putting downward pressure on domestic prices and wages. They are all restrictive and aimed at reducing consumers' purchasing power. Short of a crisis, most governments are reluctant to adopt such policies.

Thus, my judgment is that the difficulties of sustaining current account deficits have been overstated for any country whose financial markets are developed enough to be able to borrow in its own currency. Of course, this is even more so if its own currency is a reserve currency which foreign central banks are willing to accumulate.

Current account surpluses and lending

I would now like to approach the subject of imbalances from the side of the surplus countries, particularly Asian countries. The thing that stands out today is that Asian countries run large surpluses, which amount to a bit more than half the deficit run by the United States.[1] As we have seen, when a country runs a surplus on its current account, it has to be exactly matched by capital outflows in the form of loans or investment abroad. Thus, we have the counter-intuitive situation of a region consisting predominantly of developing countries lending to the richest developed country in the world. Not only does this seem to be counter to economic logic, it is also contrary to historical experience.

Developing countries are characterised by relatively small amounts of capital relative to labour, and hence relatively high rates of return on additions to their capital stock. It makes sense for funds to flow from the mature economies to the developing economies in order to receive a higher rate of return on those funds. To some extent, this is happening, principally through direct investment, but this is dwarfed by other flows in the opposite direction so that overall finance is flowing from the developing to the mature. Historically, it has gone the other way. In the nineteenth century, the main movement was from old Europe to the new and expanding United States, and this flow continued in the twentieth century as newer areas such as Australia, Argentina, Canada, etc. received funds from Europe and later the United States.

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[1] Another comparison, which takes in private capital flows as well as the current account, is to look at the accumulation of international reserves by Asian countries. In 2004, they added US$508 billion to reserves, which amounts to over 75 per cent of the US current account deficit.

There are a number of explanations for this unusual pattern of capital flows. Many people attribute it to the desire by Asian countries to keep their exchange rates low in order to maintain competitiveness. I do not wish to argue that this has not been a factor, but I think there is a more important explanation. There are two relevant facts about this pattern of capital flows. The first is that it is a relatively recent phenomenon. Table 2 below compares the pattern in 1996 – the year before the Asian crisis – with the pattern now. In all cases, the Asian current account surpluses were much smaller (or were deficits) in the earlier period than now. This pattern is not consistent with the view that competitiveness considerations were the main driver, because if that were so, Asian countries would not have waited until the past five years to put them into effect.

Table 2: Current Account

Per cent of GDP

	Japan	China	Other east Asia	United States
1992-1996	2.4	0.4	-0.7	-1.3
2000-2004	2.9	2.7	5.7	-4.6

Source: IMF

The second fact is that, as shown in Table 3, the predominant change in economic behaviour by the Asian countries between the two periods has not been to increase saving, but to reduce investment. In the case of Japan, investment has fallen by 5.2 per cent of GDP since 1996, and in the rest of Asia (excluding China), it has fallen by 8.7 per cent of GDP over the same period. China is different, in that both savings and investment have not changed by much.

Table 3: Saving and Investment in Asia

Per cent of GDP

	Japan		China		Other east Asia	
	Saving	Investment	Saving	Investment	Saving	Investment
1992-1996	31.5	29.2	40.8	40.2	32.9	33.6
2000-2004*	27.6	24.8	41.9	39.7	30.6	24.6

* Data for China only available till 2003

Sources: CEIC; IMF; RBA

My conclusion is that because of the timing and the composition of the change in the Asian current account position, much of the reason behind it can be attributed to the fallout from the Asian crisis of 1997/98 and the desire of Asian governments to avoid a repeat of it.

After the devastation faced by Thailand, Korea and Indonesia (and observed with interest by China), Asian countries felt they had to make their economies more resilient to international capital flows. The simplest way of doing that was to cut expenditure (particularly investment expenditure), keep savings high, run current account surpluses and build up reserves. Since the reserves are largely in US dollars, that means lending to the United States. There is a cost to this as it means forgoing spending and building up savings which will be lent at a low interest rate. It is a very expensive form of insurance designed to reassure international investors of the ability of the country to withstand a crisis. I remember that up until a couple of years ago, officials from Asian countries (especially China) usually started any presentation on their economy by referring to their high level of international reserves. They do not do that any more since the level has become so high that they exceed any likely need.

Thus, I think that in a world of floating exchange rates and mobile international capital, a number of emerging market economies came to the conclusion that the international financial system was so potentially unstable that the only way they could participate was by paying this large insurance premium in the form of cheap loans to the United States. I have a feeling that this sentiment is starting to change now, but it was a large part of the reason that we have ended up where we have.

This is not a new thought of mine, because I was already worrying about it in 1998 when I wrote:

"I fear that a number of emerging market countries will take…(the) safety-first policy…(of) building up large international reserves - a new type of mercantilism. The problem with this solution is that to build

up the reserves they would have to run current account surpluses for the foreseeable future. ...The final irony, if this situation eventuates, would be that we would have an international system in which the poor countries lend to the rich so they can spend more than their income."[2]

Sustainability of surpluses

I think it is possible to argue that for countries with a fixed exchange rate, surpluses may be more difficult to sustain in the long run than deficits are for some other countries. I speak from experience here as Australia faced this problem in the early 1970s and did not handle it successfully. At that time, Australia briefly experienced a current account surplus and also became a favourable destination for capital flows. As the money poured in from both these sources it had to be sterilised or it would flow directly into the banking system and through that into money and credit aggregates, with obvious inflationary results.

The problem we found was that in order to sell the official paper in sufficient volumes to soak up the inflow, interest rates had to be raised, and this induced further inflow. In the end, the monetary aggregates grew too quickly and inflation soon rose to an unacceptable rate. We came to the conclusion then that it was not possible to restrain an over-exuberant and inflation-prone economy only by domestic tightening. Exchange rate adjustment was required in order to take away the 'one way bet' aspect of the exchange rate. We eventually did this, but we were too slow and the inflation had already become entrenched.

So far, China has made a much better job of handling this situation than we in Australia did 30 years ago. And, of course, it is made easier by the fact that it is occurring in a world environment of low and stable inflation rather than the rising inflation of 30 years ago. But, ultimately, I think the point will be reached where domestic restraint has to be augmented by action on the exchange rate.

Sterilisation is not as easy as it sounds. If all the central bank does is sell official paper to the commercial banks at a below-market interest rate, it is not really sterilisation. It merely exchanges commercial banks' balances at the central bank for central bank paper, but does not offset the initial increase in bank deposits caused by the official purchase of foreign currency. For sterilisation to offset the initial rise in bank deposits, the official paper must be sold at an interest rate that attracts non-banks to withdraw deposits from the commercial banks in order to buy the official paper. This is rarely done because it would push up interest rates and attract more inflow.

Instead, countries usually rely on a combination of raising reserve requirements and direct lending guidelines to limit the growth in banks' balance sheets, and hence the money supply. These have their own set of problems for both commercial banks and/or central bank profitability, and hence cannot be maintained indefinitely.

Ultimately, the inflow of foreign funds through the current and capital accounts has to be reduced through a higher exchange rate. It is in the country's own domestic interest to do so, but it is difficult to make the decision at the right time, i.e. before the inflationary consequences in goods and asset markets show up. We in Australia did not pass that test, but I suspect China will handle it better than we did.

Conclusion

I have tried to make a number of points in this talk, but I may not have been as clear as I would like to have been. I will, therefore, conclude by restating my main points in the simplest of terms.

- it is not fruitful to approach the current needs of international policy by asking what can various countries do to reduce the US current account deficit;
- it is not clear to me that current account deficits are less sustainable (for some countries at least) than are current account surpluses;
- the current level of reserves in Asia owes much to these countries' memories of the Asian crisis, and their determination not to go through such a situation again;

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[2] "Recent International Developments in Perspective", Reserve Bank *Bulletin*, December 1998.

- the combination of rapid economic growth, a fixed exchange rate and persistent current account surpluses is not sustainable into the medium term, and it is in the domestic interests of a country in this situation to adjust its exchange rate; and
- whether this has an appreciable influence on other countries' balance of payments position is of secondary importance.