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Good morning. It is a privilege to be part of the Brussels Economic Forum and to speak before this distinguished audience. The subject of this session "Asia, the US Dollar and Global Imbalances" is certainly interesting and topical. In my view, three key questions need to be answered to address it.

First, is the present highly unusual pattern of global current account imbalances sustainable over the longer term? Economists have been warning about the potential risks from global imbalances for several years. And yet these imbalances are still with us. Nonetheless, I will argue that they clearly represent a disequilibrium: they are not sustainable in the longer term.

The second issue follows from the first: If these global imbalances are not sustainable, what has kept them going all these years?

The third question is about the inevitable adjustment. What should policymakers be doing to ensure that the process of adjusting global imbalances inevitable international adjustment process, when it takes place, is orderly and consistent with continued satisfactory global growth and inflation performance?

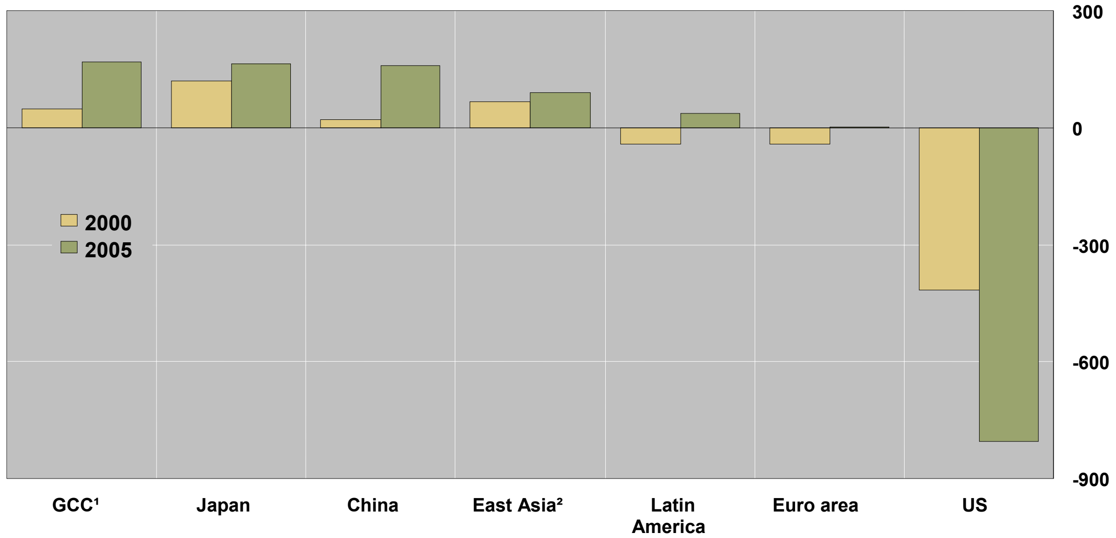
Why do I think that external imbalances represent a longer-term disequilibrium? Let me highlight three global developments that have been going on for some time now, but which cannot continue indefinitely into the future. This is exactly what I mean by a longer-term global disequilibrium.

First, recent years have seen very large and persistent current account imbalances in a number of countries and regions. The cumulative effect of these sustained imbalances has been a buildup of stocks of external assets and liabilities that are now very large relative to the underlying economies

Second, especially from the point of view of emerging markets, the imbalances are being financed in anomalous and unusual ways.

Third, the US external current account deficit itself is partly the result of an unusual distribution of savings and investment across domestic sectors within the United States.

Chart 1
Net flows: US and emerging markets
Current account balances in 2000 and 2005 in billions of US dollars



1 GCC (Gulf Cooperation Council) countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE.
2 East Asia includes Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand.

Source: IMF, World Economic Outlook, 2006 April.

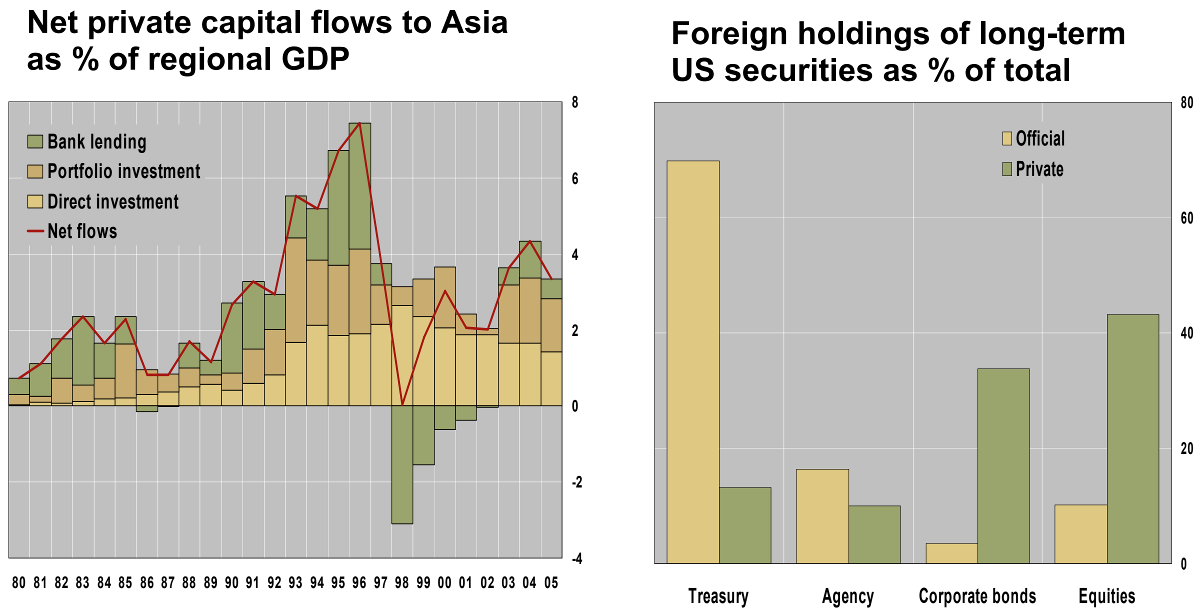
Let me focus on each of these elements in turn.

First, let's look at the unusual pattern of global current account imbalances and capital flows. Chart 1 shows current account balances in 2000 and in 2005, for different countries and groups. But of course, as we all know, the counterpart of a country's current account surplus is a *net* outflow of private and official financing to deficit countries. The chart indicates that during this period there has been one large external current account deficit – that of the United States – and a number of more modest surpluses, spread around the globe. And this pattern has become more pronounced over time. In 2000, as shown by the yellow bars, the major current account surpluses were those of Japan and East Asia, including India, Malaysia, South Korea and Thailand. By 2005, as shown by the green bars, China and the Gulf states had become major surplus economies on a par with Japan.

In the case of the Gulf states there is, of course, a ready explanation: the rise in world oil prices has caused the GDP of these countries to grow much faster than their domestic demand.

In the case of China and east Asia, however, it is remarkable that these emerging economies are a major source of net external financing for capital-rich economies, particularly the United States. I believe this anomaly is unlikely to persist. If it is not adjusted by appropriate policy actions, starting soon, it will eventually be adjusted by market forces. And this could lead to unsatisfactory macroeconomic outcomes over a number of years for many, if not most, players in the global economy.

Chart 2
Gross flows: Asia and the rest of the world



Note: Asia comprises China, India, Indonesia, Korea, Malaysia, the Philippines and Thailand.

Sources: Institute of International Finance; US Treasury et al (2005).

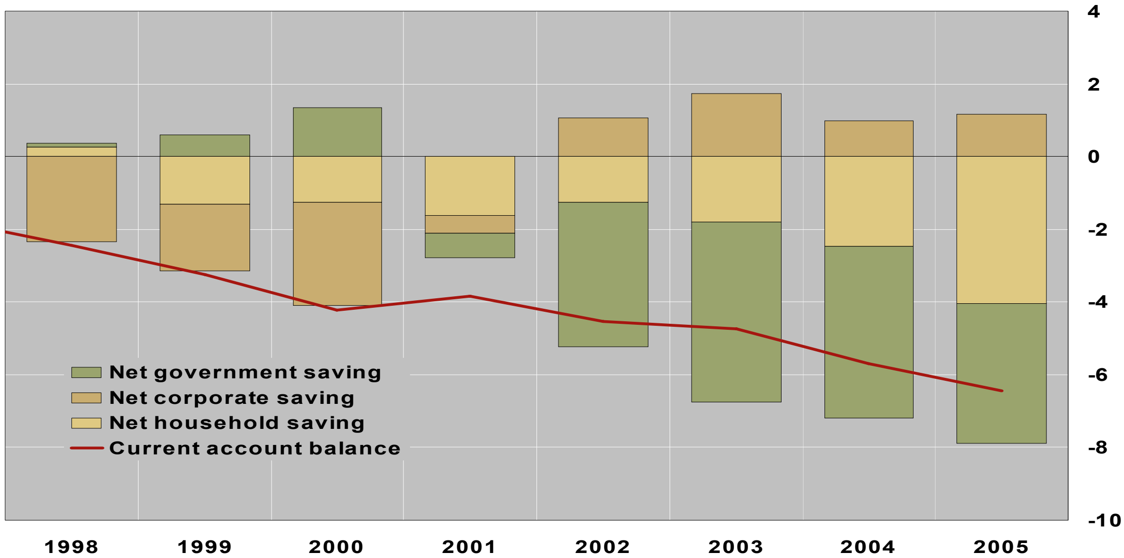
Second, there is also an anomaly in the patterns of *gross* capital flows. In a world where asset holders still hold most of their assets in their own home country (i.e. they have "home bias"), financial assets should also be traded internationally in a way that achieves more global diversification. Asset holders in different regions should be exchanging risky local assets with each other to gain more diversified – and hence less risky – international portfolios. The question is whether the gross flows we see reflect such increased diversification.

The left-hand panel of Chart 2 illustrates how the rest of the world invests in *Asia*. The green bars show bank lending, the brown bars portfolio investment and the yellow bars direct investment. The chart shows that since the Asian financial crisis in 1997-98, financial flows into Asia have shifted from bank lending to portfolio and direct investment.

The panel on the right illustrates how Asia invests *abroad*. While it shows only Asian residents' investments in various US securities, the broad patterns are evident. The yellow bars are investments by the Asian public sector, which we know to be largely central banks. The green bars are investments by the private sector in these countries. By far the larger share of Asian countries' financial investments in the United States are placed by their public sectors. And these are mostly held in US dollar-denominated fixed-income instruments – US Treasuries and agencies – rather than in US corporate bonds or equities.

When I look at the two charts, it is clear to me that we are not seeing an exchange of risky local assets that enhances global risk diversification. So the current pattern of gross capital flows is unlikely to be sustainable in the longer term.

Chart 3
US net saving by sector



As percentages of GDP.

Source: National data.

Now let us turn to the US current account deficit (the solid line in Chart 3), which has risen from 2% of US GDP in 1998 to over 5% in 2005. At root, of course, the development of this deficit depends on what is happening to saving by US households, firms and governments relative to domestic investment. But when we ask the question of who is doing the saving and who is doing the investing, the answer is surprising.

The bars in this chart show *net* savings in the United States by each aggregate sector (so they add algebraically to the US current account balance). The green bar represents the US government sector and it shows what we all know – that the US fiscal deficit is contributing to the US external deficit.

The yellow bar shows a simple estimate of *net* saving by US households. I have calculated net household saving by subtracting, from total household savings, investment in residential housing. Here we see that this measure of net saving by households has not only been negative but, in 2005, was an even bigger negative factor than the fiscal deficit in shaping the US current account deficit and its financing.

The brown segment shows the US corporate sector. Since 2002, this sector has been a net *provider* of savings – that is, the savings of the US corporate sector have exceeded its aggregate investment in fixed capital.

This behaviour by US households and corporations is highly unusual. It is surely one reason why we are in a longer-term disequilibrium.

But if these remarkable circumstances represent a disequilibrium, why has it been able to persist for so long? Again, I think there are three reasons:

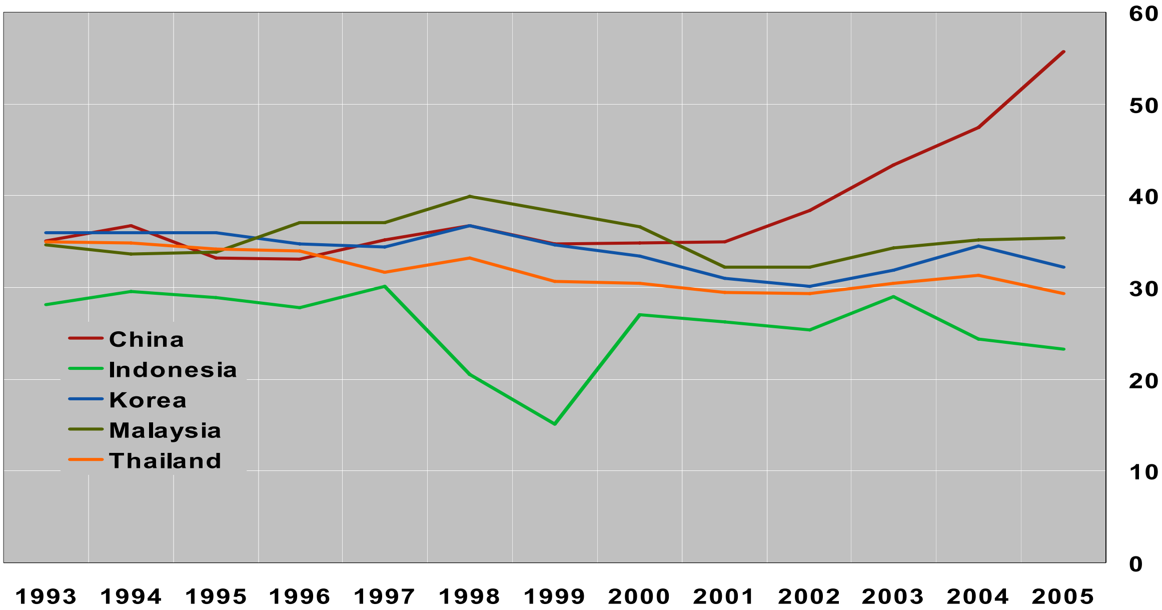
First, households in east Asia, particularly China, continue to save at prodigious rates, while investment in east Asian countries other than China still has not returned to levels that were seen prior to the 1997-98 Asian financial crisis.

Second, official foreign exchange market interventions to keep various currencies from appreciating too much against the US dollar have resulted in a build-up of the very large stocks of official foreign exchange reserves that have helped to finance the US current account deficit.

Third, the very low long-term interest rates prevailing since 2001 have supported high levels of both US residential investment and household consumption, in the process attracting considerable foreign financial flows into the US residential mortgage market.

Let me turn to each of these elements.

Chart 4
Asia still has high savings and China is saving more and more
Saving for selected countries as a percentage of GDP



Note: Savings are calculated as the sum of current account balance and gross capital formation.

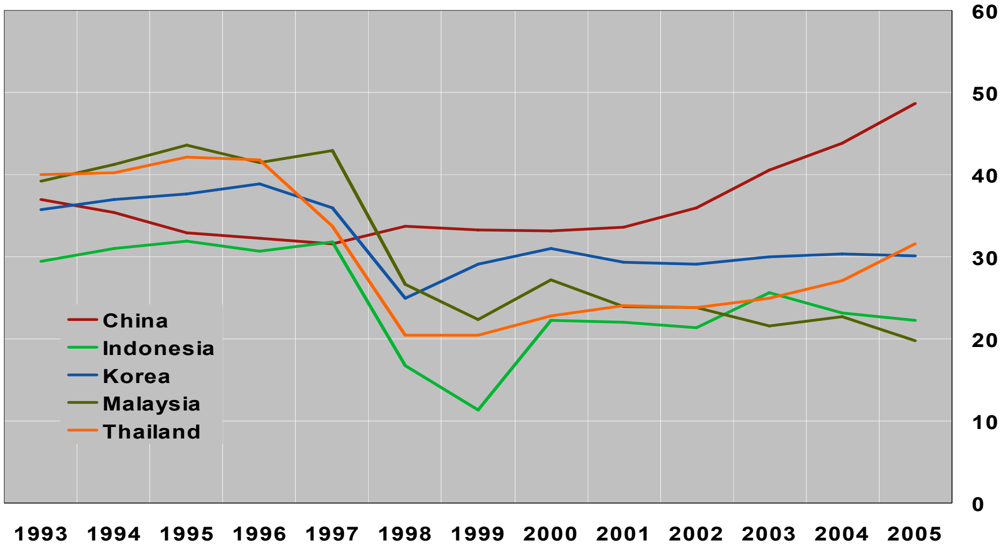
Sources: CEIC; national data.

The first factor sustaining the present skewed pattern of global current account imbalances has been the persistent tendency of many emerging economies around the world – particularly China and other fast-growing countries of east Asia – to save more than they invest.

Chart 4 reflects the well-known fact that Asians have traditionally had very high saving rates. Among the five east Asian countries shown in this chart, Korea, Malaysia and China continue to save more than 30% of their GDP. It is true that in recent years this pattern has begun to change, at least for east Asian countries other than China. In particular, the introduction of credit cards in the region was associated with a burst of spending in Korea. And several countries, such as Indonesia and Thailand, are now beginning to see some decline in saving rates.

In the case of China, however, with a population that is aging rapidly and a weakened social benefit system, the household saving rate is still rising strongly, and it is reaching extraordinary levels. According to the estimates in the chart, the Chinese are now saving more than half their GDP.

Chart 5
Except in China, investment has not returned to pre-crisis levels
Gross capital formation as percentage of GDP



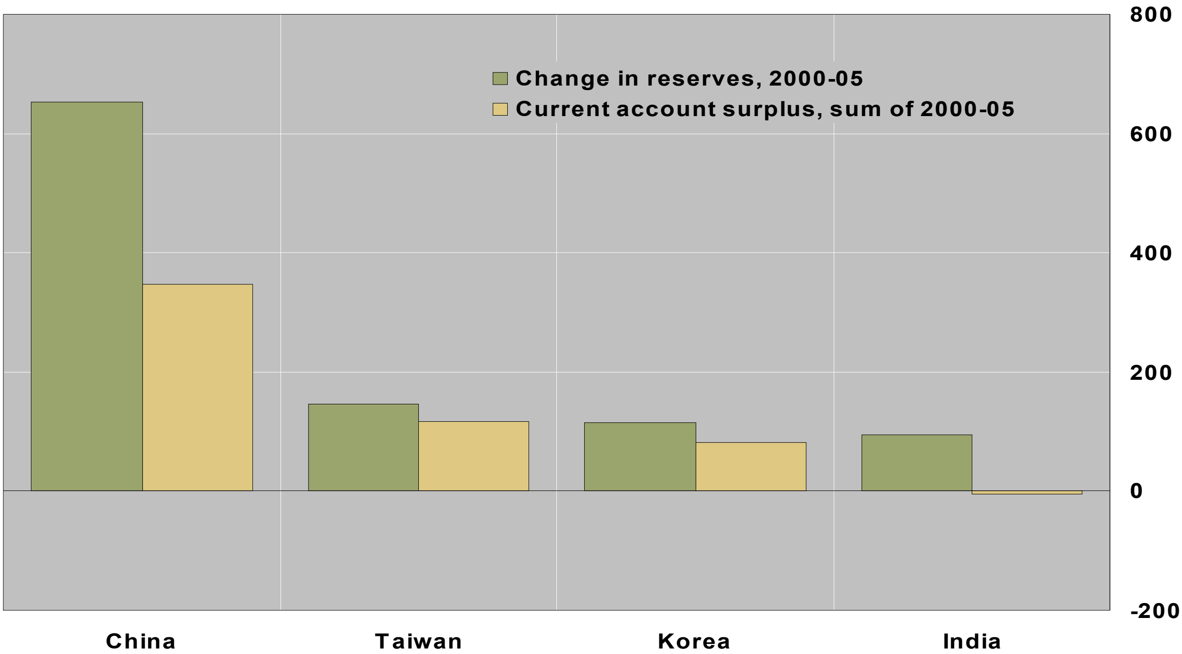
Sources: CEIC; national data.

While Asians continue to save prodigiously, you can see from Chart 5 that the level of investment has, except in China, recovered rather slowly from the 1997-98 east Asian financial crisis.

Before the Asian crisis, the five east Asian countries shown in the chart had been investing at rates in excess of 30% of GDP. But investment rates plummeted after the crisis in 1998-99, and six years later have yet to fully recover. With high savings and low investment, relative to their past behavior, these countries continue to generate current account surpluses.

Among these countries, only China (the red line in Chart 5) has seen a sustained high investment ratio since the late 1990s, and has actually witnessed an increase in investment rates beyond the levels of 1996. Even such strong investment, however, is exceeded by China's extraordinary savings rate. Hence, China's current account surplus now matches that of Japan and is also helping to finance a significant part of the US external deficit.

Chart 6
Asian reluctance to allow currency appreciation finances imbalances
Reserve accumulation and current account balances

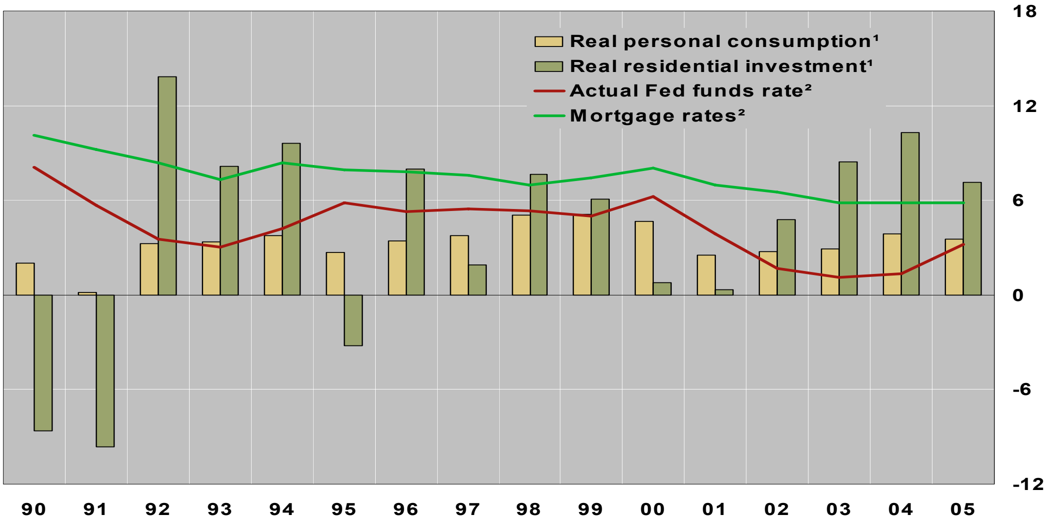


Source: IMF.

The second factor that has sustained the financing of the US current account deficit, in my view, has been the reluctance of many countries around the world, but particularly a number of Asian countries -- to let their currencies appreciate “too much” - against the US dollar. To limit appreciation of their currencies, the monetary authorities of these countries have had to accumulate US dollar foreign exchange reserves

As Chart 6 shows, four economies in Asia – China, Taiwan (province of China), Korea and India – have been accumulating official reserves in amounts exceeding their current account surpluses. In so doing they, too, have been helping to finance US external deficits.

Chart 7:
Low interest rates support US consumption and residential investment



[1] Annual changes, in per cent.... [2] In per cent; quarterly average.

Source: National data.

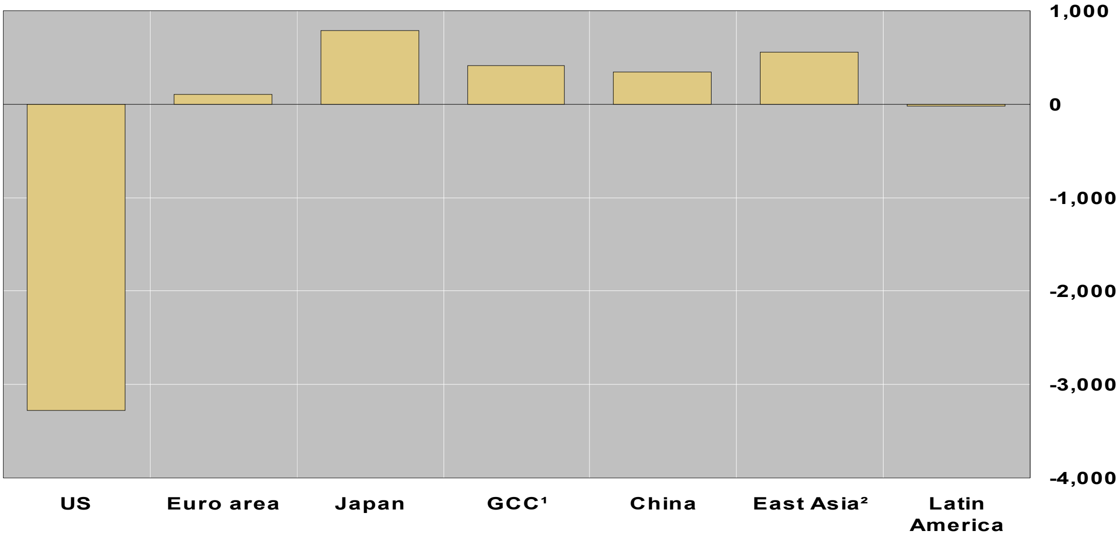
The final factor sustaining global current account imbalances has certainly been low interest rates.

Low interest rates have had a powerful stimulative impact on US consumption, an effect that has worked through both the low cost and the increasingly flexible availability of home-equity loans in conditions of sharply rising US housing prices. As shown by the yellow bars in Chart 7, real personal consumption growth has been consistently on the rise since 2001.

In addition, as shown by the green bars, the growth in US residential investment has been even stronger than that of consumption.

Such high consumption and high residential investment by American households has allowed the US economy to serve as an "engine of growth" for the world as a whole over the period since the end of 2001. And this growth has been readily financed by capital inflows attracted by the strong growth performance of the US. So this US role as "consumer of last resort" has also sustained and augmented the global imbalances that have become a cause for concern.

Chart 8
Cumulative current-account imbalances
2000-05 in billions of US dollars



[1] GCC (Gulf Cooperation Council) countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE. [2] East Asia includes Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand.

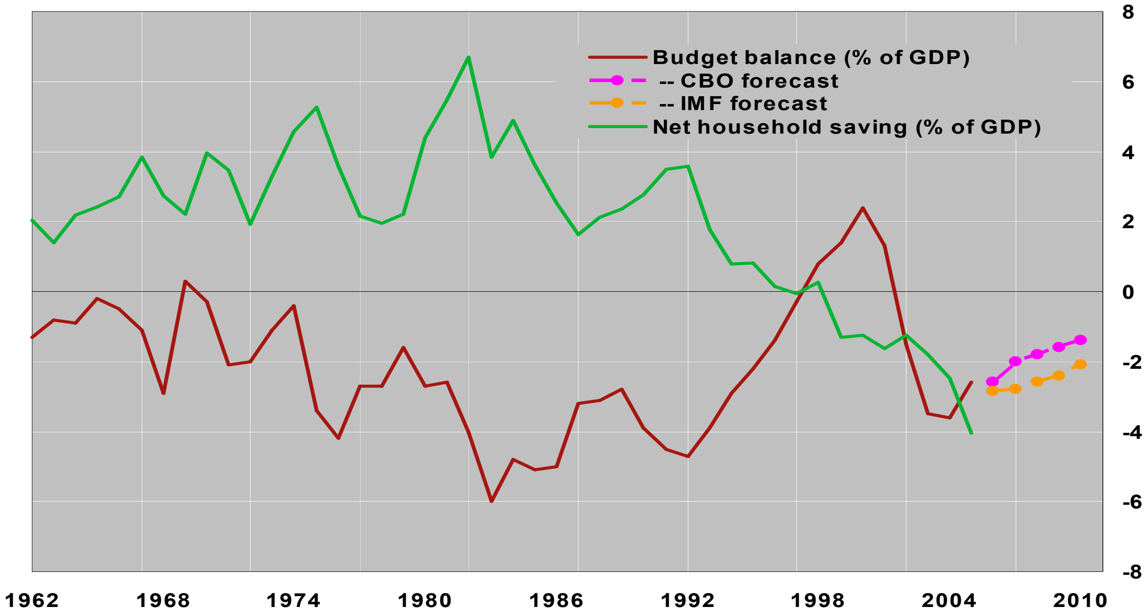
Source: IMF, *World Economic Outlook*, 2006 April.

All these factors have resulted in very large current account imbalances in recent years. Chart 8 shows the cumulative imbalances over the period 2000-05. The cumulative US current account deficit over the 6-year period – roughly the increase in the dollar-denominated liabilities of US residents to the rest of the world over that period – amounts to some $3.2 trillion!

Such large deficits can be sustained only if non-US residents remain ever more willing to purchase very large amounts of US dollar debt. We know that this cannot continue forever. Ultimately, the world must somehow adjust.

Rather than dwelling on what the international adjustment process would look like if it took place entirely through markets without supporting policy measures,, let me close by focusing on what needs to be done so that the adjustment is orderly and reasonably smooth.

Chart 9
Homework 1: Improve US fiscal balance and household saving



The multiple red lines represent the range of by the Congressional Budget Office (CBO). Net saving is defined as gross household saving minus gross residential investment.

Sources: CBO; national data.

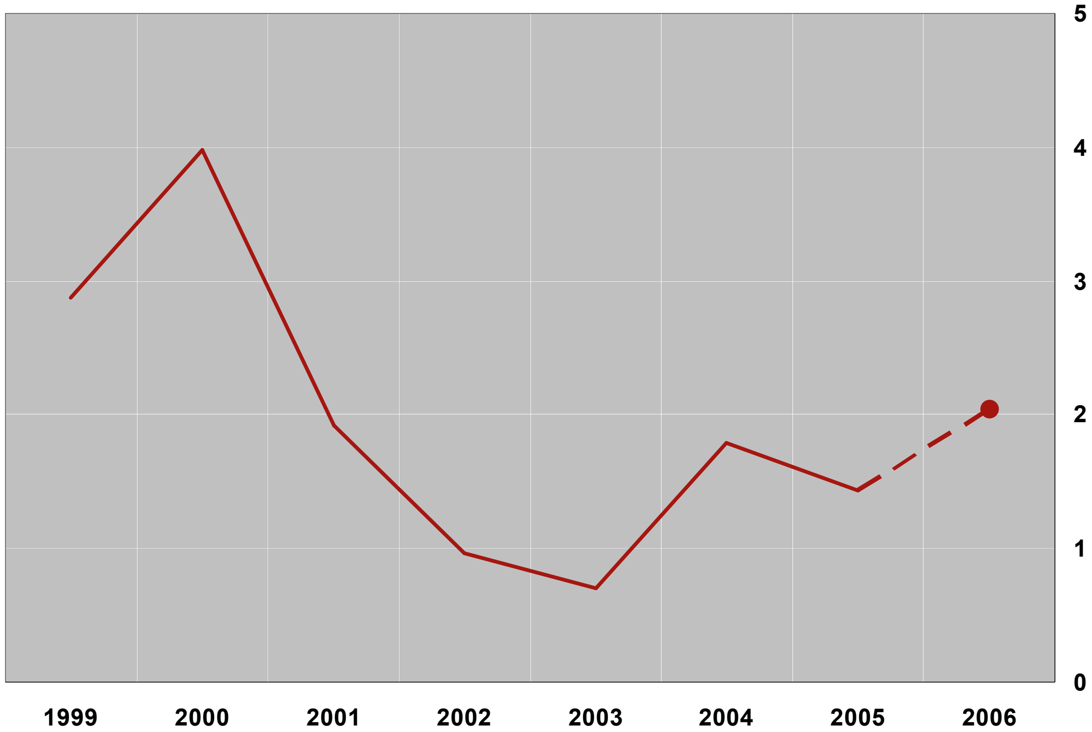
We all know the “homework assignments” for policymakers.

First, policymakers in the United States will need to work to reduce the US fiscal deficit. But US policy should also work to encourage household saving and slow down the demand for residential investment.

The red line in Chart 9 shows a very sharp deterioration in the US fiscal deficit from 2000 to 2004, followed by a stabilisation of the deficit at a high level in 2005. This stabilisation of the fiscal deficit ratio owes much too high tax revenues resulting from the current strong growth in the United States, rather than policy action. While the forecast of the Congressional Budget Office (red dots) suggests some further improvement, IMF forecasts (orange dots) and consensus private forecasts foresee a US fiscal deficit that could remain at high levels unless active policy measures are taken.

However, the highly unusual situation of negative net household saving in the United States also weighs on the US external imbalance. It might not improve much if the household savings rate continued to decline. The green line in Chart 9 shows that this decline has been going on for many years. The recent rise in US interest rates may begin to reverse this trend over time, especially to the extent that it encourages US households to save and reduces their residential investment.

Chart 10
Homework 2: Strengthen Euro area growth



Sources: Consensus Economics; national data.

Second, the economies in Europe need to continue to pick up the slack in growth. Chart 10 shows that real growth in the Euro area is picking up. But since the scope for discretionary fiscal stimulus is limited or non-existent in many Euro-area – and indeed EU – countries, vigorous implementation of good structural policies is essential to sustaining stronger growth performance.

The Euro area as a whole runs a balanced current account. However, stronger domestic demand growth here will reduce the risks associated with external adjustment in other parts of the globe. A rising tide lifts all boats!

Finally, let me turn to Asia. In China, with its aging population and weak social benefits system, I do not foresee the high savings rate declining a great deal in the near term. In fact, I think China's very high investment rate may be more of an issue, particularly if investment is not being channeled to the most productive sectors and uses. Domestic interest rates remain low in China. They need to be liberalised to be more conducive to an efficient level and allocation of investment. There is also no doubt that corporate governance needs strengthening. And since measures such as these would tend to increase China's current account surplus, the situation also argues for further steps to liberalise China's capital account; particularly for purchases of foreign assets by Chinese residents.

For the rest of East Asia, it is hard to predict whether savings rates will vary significantly from their current levels. Nonetheless, good domestic policies will be needed to get the private sector in these countries to increase productive investment and move towards internationally more diversified portfolios. And to help make such domestic policies effective, the Asian countries as a group will need to continue to foster more flexibility in the values of their currencies.