

*This paper has been published in **The World Economy**, Vol 30, No 3, March 2007, pp 363-382. An earlier version appeared as Working Paper 13/06 of the Melbourne Institute of Applied Economic and Social Affairs, August 2006.*

## **THOSE CURRENT ACCOUNT IMBALANCES: A SCEPTICAL VIEW<sup>1</sup>**

### **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. 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

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<sup>1</sup> I was stimulated to write this paper by a lecture that Martin Wolf gave in Melbourne in November 2005, and am greatly indebted to him. See Wolf (2005). I have also built on the very original and influential paper by Bernanke (2005). See also Macfarlane (2006). Some of the ideas of this paper were anticipated in Corden (1994, chapters 6 and 10).

There is a large literature on the US debt and deficit problem. See Cline (2005) and the literature there listed and summarized. His comprehensive study discusses all the issues. For factual information and also detailed descriptions of savings and investment developments in many countries see International Monetary Fund (2005,2006), and also Orsmond (2005,2006). See also Lee, McKibbin and Park (2006) for a simulation exercise showing the implications of the current account imbalances between the US and the East Asian countries being removed. I am especially indebted to Robert Z. Aliber for extensive discussions and comments, and also to Guy Debelle, Vijay Joshi, Ian McDonald, John Martin, and David Orsmond, for valuable comments on earlier versions of this paper.

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. Of course I did not invent this concept or idea. A thorough exposition of the theory of intertemporal trade can be found in Chapter 1 of Obstfeld and Rogoff (1996). Here I shall apply this concept to reflect on the much-discussed “current account imbalances” issue.

## **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 United States 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 in this form of trade as in any other. 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. It is also possible that it has undesirable income distribution effects<sup>2</sup>. My

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<sup>2</sup> In this paper I do not take up income distribution issues purely for reasons of space. It would certainly be worth doing. I have brief remarks on “exchange rate protection” where issues of sectoral income distribution do arise.

suggestion is that the normative theory of trade policy, as expounded, for example, in Corden (1997) is also applicable to this subject of intertemporal trade.

### **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 United States 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 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. First, 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 United States, Spain, the United Kingdom 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<sup>3</sup>.

### **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

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<sup>3</sup> Of course the real interest rate is to be distinguished from the nominal interest rate. The difference between them depends on inflationary expectations. Furthermore, the real interest rates in different countries, while generally moving together when there is an open capital market, are not identical. Risk factors differ, including exchange rate risk, capital mobility is not usually perfect, and short-term rates particularly are determined by various countries' monetary policies.

the United States 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. More details of factors determining saving and investment in the surplus countries can be found in International Monetary Fund (2005, 2006) and in Orsmond (2005, 2006).

The most interesting case is that of China. On the basis of the figures available, savings have been about 50% of GDP while 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? I am in no position to judge, but presume that 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.

While one can understand high private savings, it is hard to justify high public savings, 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. It seems extremely reasonable therefore 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.

In China and some other Asian countries another explanation of the current account surplus, or at least a part of it, is the deliberate pursuit of “export-led growth” Exchange rates have been fixed to the dollar, or, at least there has been foreign exchange intervention by the central bank designed to prevent or limit appreciation. The motive may have been to build up foreign exchange reserves, in which case the improvement of the competitiveness of export industries is just a by-product. But it is also likely that one motive has been to deliberately maintain or improve the competitiveness of export industries, in which case the build-up of foreign exchange reserves is the by-product. This is really a form of protection, industries producing tradeables are protected at the expense of producers of non-tradeables. I have called this “exchange rate protection”<sup>4</sup>

It is important to understand that the monetary effects of such exchange market intervention need to be sterilised (as they mainly have been in China) if the effects on export competitiveness are not to be eroded by domestic inflation. Such sterilisation (sale of bonds by the central bank) requires a reduction in domestic demand, brought about by a diversion of funds from the government or the private sector to the central bank. Hence, in the final analysis there must still be an increase in saving or fall in investment, whether private or public.

An issue that is important but not directly relevant to the current account issue is that some Chinese funds would have been much

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<sup>4</sup> See Corden (1994, 1997). It is interesting to consider the motives for this kind of protection. It may just be a matter of responding to interest groups in the export and import competing sectors of an economy. In addition, in the case of Asian developing countries that have pursued export-led growth policies there may have been some kind of implicit infant industry argument for protection, based on the belief that exporters have to go through a learning process which involves externalities or which needs initial assistance or guidance for whatever reason. Indirectly exchange rate protection is also practised by the United States when US official pressure is put on China to appreciate its exchange rate.

more profitably invested (from the Chinese point of view) in the international private capital market rather than lent directly to the US Treasury by buying low-interest Treasury bonds. The recent relaxation by the Chinese authorities of controls on capital outflow is likely to bring about a thoroughly sensible shift towards investment in the world private sector, including of course the US one<sup>5</sup>.

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, 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 United States, the United Kingdom, Spain and Australia. These reactions, leading to significant current account deficits of these countries, can also be regarded as rational. If one regards current account “imbalances” as bad, then clearly the “fault” lies with the countries that have generated the exogenous changes that started off the process. But this common way of putting the matter seems unreasonable if we accept that the surpluses have been generated by (fairly) rational behaviour. The fact that the market generates an equilibrating mechanism simply demonstrates the virtue of the market.

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<sup>5</sup> This point is stressed in Summers (2006) and also applies to the investment of the reserves of other Asian developing countries. An interesting proposal for “controlled capital account liberalization” has been put forward in Prasad and Rajan (2005). A portion of capital inflows would be securitized through closed-end mutual funds that issue shares in domestic currency, use the proceeds to purchase foreign exchange from the central bank and then invest the proceeds abroad. Incidentally, it needs to be remembered that Japanese private investors did not do so well when they diversified into US entertainment and other companies in the nineteen eighties.

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? I shall come to that shortly. 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 United States. In other words, why has the United States 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). Cooper (2006) has pointed out that in both cases the population is rapidly ageing. On the one hand this has raised their savings 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**

I come now to 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 United States. 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 gone 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 nineties (sometimes described as a “liquidity trap” situation). 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 United States 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.

Thus it has been argued that the high US current account deficit was an inevitable result of the equilibrating process generated by the “savings glut” of the various surplus countries<sup>6</sup>. For those who regard the US current account deficit as undesirable, no fault therefore attaches to US policy. In this view we can forget US interest groups, wars of choice, and the anti-tax ideology. Actually, without intending to, the United States has done a service to the world in the name of John Maynard Keynes. This implies that, given the “savings glut” that generates current account surpluses for some countries, one way or another the

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<sup>6</sup> I have in mind Bernanke (2005) here. The term “savings glut” comes from Bernanke (2005) and refers to a shift into an excess of savings over investment in these surplus countries. Since the shift into surplus in the case of many countries (though not China or the oil exporters) was caused by a decline in the investment ratio to GDP, while the savings ratio did not change much, it has been suggested that the term is wrongly named (perhaps it should be investment shortfall), but the term is convenient and I shall use it in the rest of this paper. A criticism of the Bernanke argument is in Cline (2005, pp. 202-7)

United States must generate a current account deficit to equilibrate the system. In this case it is assumed that Keynesian fiscal policy is the equilibrating mechanism insofar as the interest rate cannot adjust sufficiently. I must add that even if the real interest rate were still positive, demand stimulus purely through interest rate adjustment might not be enough to maintain world aggregate demand. Private investment and consumption may not increase quickly enough when interest rates fall.

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 savings glut coming from the countries that have actually turned out to be the surplus countries. In that case real interest rates in the United States 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 United States, 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.

Looking at the current situation (2006), the recent oil shock has transferred some of the surpluses from oil importing countries to

oil exporters. It has also increased the US deficit. It has, presumably, been the main reason why the US current account deficit increased from \$668 billion in 2004 to \$805 billion (or 6.4% of GDP) in 2005. The sum of the current account surpluses of the oil exporters in 2005 was greater than the combined surpluses of Japan and China, and was 43% of the US current account deficit. (See Table 1) For the world as a whole the inevitability of some large deficits, whether exogenous or endogenous, remains. And the principal deficit country remains the United States.

### **Those “Unsustainable” Imbalances: Two Scenarios**

Now I come to the heart of the issue, as it is widely seen in writings on the subject, whether explicitly or implicitly. It is 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 United States, so that any crisis will revolve around the United States and the dollar. Above all, the issue then appears to be: can the United States (and especially the US government) continue to go into debt at the present rate?

The most thorough analysis and survey is by Cline (2005). Here I do not aim to forecast but rather to outline several plausible and quite distinct scenarios<sup>7</sup>. There are two principal scenarios, and some others that I will discuss briefly later. In the extensive literature on this subject they are not always kept separate. Of course, we may get elements of several scenarios, either at the same time or sequentially.

In the first scenario the world real interest rate rises. This would happen if the savings glut of the surplus countries declined,

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<sup>7</sup> Possibly by the time this paper is published it will be clearer which scenario has turned out to be the most relevant one. This paper is written from the vantage point of mid-2006, but, to emphasize the point, my aim is to sort out the analytical issues, not to forecast.

without initially an associated reduction in the US fiscal deficit nor an ending of the boom in US private sector borrowing. This is the eventuality that many advocates of reducing imbalances now may have in mind. 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 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 have not before that). There will be political difficulties.

In addition, the dollar is likely to decline. This needs some explanation.

The increased expenditure in the surplus countries resulting from the reduction of their savings and the increase in their domestic investments – that is, the reduction in the savings glut – will increase the demand for US goods, and this, in itself, might be expected to appreciate the dollar. But demand for non-US goods will also go up so one cannot be sure about that. It is the capital market effect that is likely to be decisive. Since the surplus funds of the surplus countries have been overwhelmingly invested in the United States the demand for dollars relative to other currencies will certainly decline, and this will 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

while the savings glut of many surplus countries continued. The surpluses of oil exporters might even increase above current levels. 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 United States there would be an offset to the deflationary effects of a fiscal contraction<sup>8</sup>. 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 United States.

### **Three More Scenarios**

Another possible scenario is the following. The savings glut of the surplus countries may continue, but they might redirect their foreign investments away from the United States (especially the US Treasury), and invest in other countries, say in Europe, Latin America, and India. The interest rate facing the United States would then rise and the dollar would certainly fall, while interest rates in Europe and Latin America would fall. But given the high international mobility of capital the differential movement in real interest rates would not be great. The main effect would be on the dollar. At present, a large redirection of funds of this kind seems unlikely, but in time, it is possible. That is a third scenario, the possibility of which is frequently feared.

There are actually two distinct explanations for this scenario. The switch of surplus countries’ foreign exchange accumulations or capital exports away from the United States

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<sup>8</sup> I am again assuming that the capital market effect outweighs the goods market effect. Reduced borrowing by the US Treasury will draw less capital into the United States and so depreciate the dollar. Admittedly, expectations effects could complicate the story.

might be motivated by expectations of dollar depreciation, in which case this scenario actually rests on the underlying stories of the first two scenarios. Alternatively it might be motivated by expectations of higher profitability of potential investments outside the United States or reduced profitability or higher perceptions of risk (other than exchange rate risk) in the United States itself.

Then there is the “coordination scenario.” In this case the “imbalances” are reduced while the real interest rate does not change (much). The surplus countries increase their spending while the deficit countries reduce theirs. This might be brought about gradually by coincidence, or achieved through some kind of coordination (on which more below). In that case, the world real interest rate may not change much, and the dollar will again fall.

Finally, I come to the most interesting scenario of all. It is fully expounded in Cooper (2006). There might be no big changes in real interest rates or the dollar, essentially because the imbalances can go on! Of course they need not continue in all details, and the size and composition of world surpluses might change. Much depends on the trend in aggregate world savings outside the United States. But a large US current account deficit of present magnitude in relation to US GDP could well continue for some time – perhaps a long time.

“Why are so many foreign funds being invested in the United States? The answer lies partly in the attractiveness of US financial assets, which are claims on a robust, innovative economy, with good yield, liquidity, security, and relative stability... Nearly half the world’s marketable securities (stocks and bonds) are in the United States.” Cooper (2006) points out that the US economy accounts for 25-30% of world economic output. He then has a calculation that relates the annual inflow of foreign savings into the United States to total annual world savings (excluding savings in the US itself). In the absence of

home-bias it would be, say, 30% of world savings. In fact, it is 15%, which covers the current account deficit of 2005 plus US investment abroad. If home bias declined more might come in; if world savings declined less might. Cooper also has other calculations that I cannot easily summarise here which suggest that foreign claims on the US are not excessive, and could grow. There is also extensive analysis of this kind of approach in Cline (2005, chapter 5)

### **A Dollar Crisis?**

Need there be a dollar “crisis” or even a “disruptive” one? It seems to follow from all the scenarios, other than the fifth (the Cooper scenario), that the dollar must eventually depreciate, possibly to a large extent.<sup>9</sup> The question is whether such a depreciation must be sudden. Perhaps it could be gradual.

In the case of the first scenario (where the world’s savings glut declines) 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 United States. Yet, here also, one can have doubts whether depreciation need be

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<sup>9</sup> Of course, the depreciation must be real and not just nominal. This is stressed in Lee, McKibben and Park (2006). Obstfeld and Rogoff (2004) argue that the real depreciation required to reduce the US current account deficit significantly will have to be very large.

sudden<sup>10</sup>. Given uncertainty about policy changes in various countries, including the United States, it is also possible that expectations change gradually, so that depreciation is gradual, as indeed it has been so far (mid 2006). Furthermore, there may be a widespread belief that something like the fifth scenario (the Cooper scenario) is the correct one, and this may also slow up actual depreciation.

Could there be a dollar crisis similar to the 1997 Asian crisis? The answer is that the United States is “different”. In all the emerging market crises, beginning with the debt crisis of the 1980s and ending with the Asian crisis, borrowing was in foreign currency. But the United States government has been borrowing in dollars. Furthermore, it is not trying to keep the value of the dollar fixed to other major currencies. A most important point is that dollars are so widely held in the world as reserves (especially in Asia), that there may be a built-in stability mechanism in the event of dollar depreciation. Central banks will be reluctant to allow rapid capital losses on their vast holdings, and they will therefore not move rapidly out of dollars.

The declines in the dollar (in real terms) which are indicated by the first four scenarios would have favourable effects on US import competing and export industries, but would also have a variety of unfavourable effects in the United States and elsewhere. US industries and consumers purchasing imported inputs would, of course, lose. Pressures for protection in the United States would ease, and in countries where industries suffer from strengthened competition with US products - probably mainly in Europe - would increase. In Europe, in particular, resources would have to shift out of tradeables into non-tradeables, so that domestic demand would have to increase. Some European surpluses would need to decline and deficits to increase. Both monetary and fiscal policies would need to be flexible. Non-US holders of dollar assets would lose,

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<sup>10</sup> I emphasize again that this is not a forecasting paper. One can have doubts, which is a probability statement, but sudden changes do happen!

at least if the depreciation were unexpected so that interest rates would not have compensated them.

All these are obvious implications of a substantially reduced US deficit. Both the dollar depreciation and the rise in interest rates (if the first scenario eventuated) would have various redistributive effects. Such a rise in market-determined long-term interest rates, when combined with the dollar depreciation, would not need to cause a recession in the United States because of the offsetting effects of the depreciation, as well as the scope for compensating monetary policy (which would reduce short-term rates). Current discussion often emphasizes the adverse effects of interest rate and exchange rate changes on some parts of the economy and ignores the favourable effects on others. But there certainly would be some unfavourable effects.<sup>11</sup>

It is worth recollecting a recent piece of history. Beginning in 1983 the US developed a large current account deficit, primarily explained both by the Reagan fiscal expansion and by the real appreciation, which began earlier owing to the Volcker monetary contraction from 1979. The current account deficit reached a peak in 1987 and then declined. The deficit from 1983 to 1990 averaged about 2.5% of GDP, which was indeed much less than recent deficits (5-6% of GDP). And there was a stock market crash in 1987 but with no significant effects on the economy. The 1991 recession certainly contributed to the practical disappearance of the deficit, but one cannot argue that the earlier deficit “caused” the recession. The movement in the dollar was more dramatic. Here, indeed, is the potential historical parallel. In real terms the dollar rose 50% from 1979 to February 1985, and then turned sharply down, until by 1987 it was back where it had been in 1979. Yet the turnaround involved no crisis in the form of recession, even though during

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<sup>11</sup> Cline (2005, pp. 175-80) discusses the likelihood of a “hard landing” in the United States, that is, a recession caused by a sharp rise in interest rates, possibly brought about by monetary policy that deliberately raised short-term interest rates so as to moderate a severe depreciation.

the last stages of the real appreciation (around 1984) a crisis was often predicted.

### **A Long-term Problem: The Need for Investment**

We can really think of our high-capital-mobility world as if it were one single closed economy. We can imagine some households prudently saving for bad times. They are anticipating their needs in the future when there are many old people and few workers, or they are allowing for the possibility of various disasters, whether the effects of global warming, of epidemics, of earthquakes or of wars. They are like the Japanese and the Chinese. There may be other households that imprudently dissave, using the borrowed funds to “let the good times role”. Their dissaving may solve the immediate aggregate demand (Keynesian) problem. But it will create a problem later when the debt has to be serviced and eventually perhaps paid back completely. Unless there is sufficient underlying productivity growth based on previous investment, there has to be investment to prepare for future needs, perhaps the very needs anticipated by the prudent householders. To an extent saving by some has to be matched by appropriate investment, rather than just dissaving, by others. If a government follows a short term Keynesian deficit policy, entirely justifiable for Keynesian reasons, it cannot neglect the long-term when its non-interest deficit will have to turn into a surplus. It must be able to raise sufficient taxes or directly to generate income<sup>12</sup>.

One can apply all this to the current US deficit’s role in the world economy. US fiscal policy has indeed played a Keynesian stabilisation role in the world, though by chance, and it plays such a role now when the high savings of the oil exporters are added to the net savings of the prudent Asians. But what about

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<sup>12</sup> Formally, this is a potential problem if the debt/GDP ratio is rising over time, or even if it is very high to start with.

the long-term? Will the US government be able to service its debt, including repayment of principal?

The long-term problem is eased by the United States having a high productivity level compared with most other developed countries (including, as has been recently noted, the productivity of its own overseas investments), and a fairly high rate of per capita productivity growth. Hence the tax base will certainly increase and is adequate even now to enable its government to generate the necessary taxes to meet its debt obligations. But a central issue is whether there will be a political willingness to increase tax rates when needed. The anti-tax ideology may have to be given up.

All this is discussed in Cline (2005). Cline recommends a major fiscal adjustment, but also arrives at the important judgement “that any net external debtor difficulties for the United States would be from a liquidity rather than a solvency problem.” (Cline, 2005, p.268). I find that convincing<sup>13</sup>. In addition, Cooper (2006) has pointed out that, for various reasons, US saving and domestic investment are not as low as the figures suggest. He mentions expenditures on education, R&D, and consumer durables as representing (partially or wholly) investment that is not counted statistically, some yielding very high returns. In addition there has been a striking rise in household net worth, owing to capital gains in housing and equities.

In 2005 the US “general government “ fiscal deficit was 4.1% of GDP (while the current account deficit was 6.4%), but by mid-2006 it appeared to be much lower because of higher tax

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<sup>13</sup> A reader of this paper has asked me to explain what is meant by a “liquidity problem”. There might be a run on the dollar, which would depreciate the dollar and (depending on the associated monetary policy) raise interest rates. That would be a short run “hard landing,” possibly causing a recession (if the interest rate rose sharply). It would also cause problems for firms holding foreign-currency denominated assets, or dependent on imported inputs. I interpret Cline as describing this as a “liquidity problem”. There is no “solvency problem” because the US is wealthy enough to be able to meet its foreign debt service obligations without excessive sacrifice and the government can always raise the necessary taxes. That is my understanding. With regard to government debt, the political ability to raise the necessary tax revenue seems to me crucial.

collections resulting from higher corporate profitability<sup>14</sup>. But surely a long-term problem may remain. It involves future budgetary prospects that are widely discussed – increased spending for Medicare, Medicaid, and social security, as well as likely new expenditures (eg homeland security) that one cannot predict in detail.

The general point is that world saving coming from the surplus countries (and indeed all exogenous world savings, whether done in surplus or deficit countries) must be matched by adequate and productive world investment, and not mainly by (endogenous) dissaving in deficit countries. And this investment must be suited to the likely needs of the world's population in the future. Furthermore, if the current debt has been incurred by a government, as has been partially true in the current US case, the government must eventually be able to transfer resources through taxes from the private sector which, presumably, has done much of the investment, or has benefited from it even when the government itself has carried out much of the investment (for example, in infrastructure). The US private sector is very flexible, and will no doubt adjust when needed, but will the US political system allow the public sector to adjust – that is, raise taxes or cut spending?

It is important to stress that there is no particular need for the gaps between saving and investment (the current account imbalances) in individual countries to be reduced. This is the basic message from the theoretical discussion at the beginning of this paper. There are gains from intertemporal trade, which means that it is efficient for savings to be invested wherever they are most productive. The Japanese and the Germans may be high savers for demographic reasons, but this does not mean that they cannot benefit from the high productivity of investments in the United States or other countries, such as Brazil, Australia or eventually China and India. This is the case

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<sup>14</sup> See Financial Times July 12<sup>th</sup> 2006. A forecast for 2006 by the Office of Management and Budget of 2.3% of GDP is mentioned. Time will tell!

for intertemporal trade, and thus the case against “home bias” in investment allocation<sup>15</sup>.

How does the present situation compare with the aftermath of the first oil shock? After the first oil shock, in 1975 and 1976, there was much talk about “allocating” the inevitable current account deficits that would correspond to the oil producers’ surpluses. That was unrealistic then and a similar policy proposal would be unrealistic now. In fact, the deficits were allocated by the market in the recycling process. The big international banks were the intermediaries. In particular, a limited number of emerging market countries, notably Brazil, Korea and Argentina ran the deficits that balanced the surpluses. Much of the resulting increases in investment were undertaken by the governments or by parastatal enterprises of developing countries. In retrospect more cost-benefit analysis should have been applied. Big mistakes were made. But, like now, it was a period of cheap and easy credit. The crash came because of an exogenous shock, namely the high interest rates and recession brought about in the United States by the sudden imposition of monetary restraint designed to reduce or stop inflation (the Volcker shock). Problems were intensified by the attempts to maintain fixed exchange rates.

What is different now? Much is the same. It is again a period of cheap and easy credit. Some housing markets are waiting to crash. This time the United States is the principal recycler, incurring the debts that the recycling process requires. But the dollar floats, and the United States has a stronger economy than any of those emerging market countries had. It will also help the United States – though not the creditors – that debts are denominated in dollars.

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<sup>15</sup>It has to be granted that there are certain possible qualifications to this case for intertemporal trade when it is put in extreme form; these qualifications are actually similar to the terms-of-trade argument for protection in trade theory, and also to some other protectionist arguments that might have validity in a second-best sense. Information asymmetries in favour of home investments might also justify some home bias.

## What about Policy Coordination?

Suppose policy coordination in the international interest were possible, what *is* the international interest? This international interest must be distinguished from the sum of each country's or government's national interest as perceived by them.

One might agree that big changes in anything – such as the world real interest rate and the value of the dollar - are undesirable in themselves, though they may be necessary to achieve other desirable objectives. Ignoring the other objectives, this view leads to the well-known prescription designed to avoid short-term problems, namely that the surplus countries should reduce their savings and increase their domestic investments, while the United States should increase its savings and perhaps also reduce investment. Presumably this prescription would also apply to other deficit countries. The imbalances would then be reduced with minimal effect on the real interest rate. The dollar would fall, but a greater fall later might be avoided.

But reducing the imbalances deliberately would have costs, given that there are gains from intertemporal trade?<sup>16</sup> The real interest rate could also be kept fairly steady if surpluses and deficits continued as they do now. As I have noted earlier, it is the fear of a later dollar crisis that motivates this kind of prescription.

In the absence of such coordinated reduction of imbalances there are at least the two scenarios discussed earlier to reflect upon.

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<sup>16</sup> Here is an example. Australia had a current account deficit in 2005 that was 6% of GDP, almost the same as the US. Should that deficit be reduced as part of a coordinated process? Both its savings propensity (20%) and its investment ratio (26%) were substantially higher than those in the US and the UK. The investment ratio is high, and may be even higher in coming years, owing to the resources boom caused mainly by the high growth of China and India. Why should part of this not be financed out of foreign savings? This is just where new worldwide investment should go.

First, suppose the world real interest rate rises. As noted earlier, 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. Owing to the higher interest rates US private spending would fall, given that borrowing will have become more expensive. Thus the US current account deficit would be naturally reduced by higher interest rates. In addition, there would be an inducement to tighten fiscal policy. In this case the market, operating through interest rates, could be allowed to work. There would be no need for coordination.

Second, suppose that the real interest rate falls, possibly to a very low level. This would happen if the savings glut of the surplus countries continued or even increased, while the US fiscal deficit were reduced and perhaps US household savings rose exogenously. There would then be a danger of a “Keynesian situation” - that is, the threat of a world recession. Because of the low world real interest rate individual countries’ monetary policies would become ineffective. In order to avoid such a recession, should the surplus countries be encouraged to save less or to invest more at home (relative to exporting capital) than before? In my view one should be reluctant to discourage prudent savings, nor is it efficient from a world point of view to force or encourage a greater home-bias in investment than exists naturally. (This is also an argument against the previous policy of coordinated reduction of the imbalances).

Instead, all countries should be advised and encouraged to increase profitable or sound investment, whether private or public, using the cheap borrowed funds from the high-saving surplus countries. For example, if the oil price rises further and there are supply difficulties for political reasons, let the oil importers invest in energy saving or oil-substituting ventures. In the extreme case where there is the prospect of a world recession and monetary expansion is likely to become ineffective in expanding demand – i.e. the Keynesian situation –

there is a case for an attempt at coordination among the larger economies (whether surplus or deficit countries) to bring about some mutual fiscal expansion. At the minimum the IMF might give encouragement and leadership. All the major countries – including the Eurozone countries – need some fiscal policy flexibility for such an eventuality.

A separate issue is whether policy coordination is actually possible. I have in mind the current proposals for coordinated reduction of imbalances, not the coordination that may be needed in a Keynesian situation. One can be brief here. Will governments accept policies that they do not perceive as being in their own direct interests? Have they done so on earlier occasions? Which countries will be involved in the coordination process? Currently one can assume from well known recent experiences that the US Administration will do whatever it wants to do. On the other side there are many surplus countries, with Japan, China, Russia, Saudi Arabia and Germany the largest net savers. Can they be persuaded to consume or invest more at home, and hence make less use of the international capital market? Why should they? It is not necessarily in their interest. Why forgo gains from trade?

Coming back to the United States, presumably coordination for the US would mean getting China to allow its exchange rate to appreciate. But, as Table 1 shows, China is only a small part of the world story. Furthermore, as I have noted earlier, management of the nominal exchange rate will have little effect unless there are associated changes in aggregate demand, and such changes may or may not fit in with current Chinese objectives.

## **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. Households in various developed countries, including the United States 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, as described in detail in International Monetary Fund (2005,2006) 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 while US fiscal policy became significantly contractionary relative to its current level. For this eventuality fiscal policies not just in the United States, but also elsewhere, notably in Europe, should be flexible.. The second potential problem, much emphasized 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 generally, difficulties for borrowers, and especially the US government.

These are all potential short or medium term effects. The fourth problem, which is essentially long run, 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 has been discussed fully in Cline (2005), and relates to two issues: first, whether investment in the United States is adequate, and second, whether the US political system is capable of increasing tax rates required to fulfil various future obligations.

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**Table 1**  
**CURRENT ACCOUNT IMBALANCES 2005<sup>17</sup>**  
**Billions of US Dollars**

Source: IMF *World Economic Outlook April 2006*

|                                   |       |        |
|-----------------------------------|-------|--------|
| 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  |

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<sup>17</sup> All countries with a deficit or surplus of \$40b or more are listed, except for groups (marked \*) which also contain smaller imbalance countries.

|                    |       |
|--------------------|-------|
| Germany            | 114.8 |
| Switzerland        | 50.7  |
| Netherlands        | 40.0  |
| NICs <sup>18</sup> | 85.6  |

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<sup>18</sup> *Newly Industrialised Countries: Singapore (\$33.6b), Hong Kong SAR (\$19b), Korea(16.6b), and Taiwan PoC (\$16.4b)*

