

ISSUE 2005/02
DECEMBER 2005

bruegelpolicybrief

GLOBAL CURRENT ACCOUNT IMBALANCES: HOW TO MANAGE THE RISK FOR EUROPE

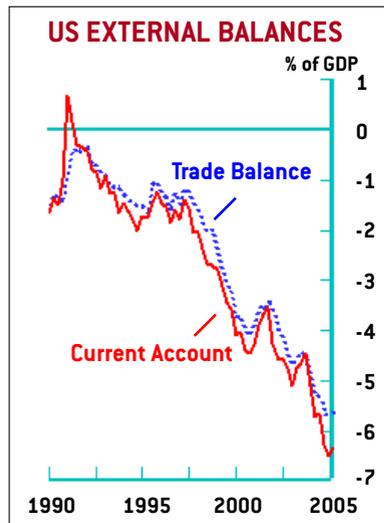
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SUMMARY The evolution of global current account imbalances, especially the huge and growing US current account deficit, has been the most alarming global economic development in recent years. **So far, European policymakers seem to have watched the growing imbalances without much concern, in the hope that the EU will be largely unaffected by the inevitable correction of the US external deficit. This apparent complacency is unwarranted. Europe may not be part of the global current account problem, but it is bound to be part of the solution.** The US current account deficit must narrow eventually and this process will almost certainly involve a significant depreciation in the dollar. The more stubbornly Asian countries refuse to adjust their exchange rates and current account surpluses, the larger will be the appreciation of the euro and the resulting deterioration in the euro area's current account balance. The sharper the adjustment and the larger the share of this adjustment that falls on Europe, the greater the risk of deflationary pressures and a severe recession in the euro area.



Source: Bureau of Economic Analysis

POLICY CHALLENGE

To prepare for global current account adjustment, Europe should adopt a policy of risk management. The domestic macroeconomic consequences of adjustment will be less severe if policies aimed at creating more flexible markets are introduced, especially in the services sector. Fiscal policy can cushion some of the shock to aggregate demand that will accompany adjustment. To facilitate this, European governments should now be striving to improve fiscal positions. Finally, the ECB should make it clear that it would respond to deflationary pressures by easing monetary policy significantly, thus avoiding the risk of deflationary expectations that might raise the cost of adjustment even further.



UNLIKE their counterparts in the US, policymakers in Europe don't appear to be losing much sleep about global current account imbalances. That may be about to change. As the US external deficit continues its steep descent into uncharted waters, there may be many sleepless nights ahead for policymakers everywhere in the world.

There has been a great deal of discussion recently of global current account imbalances that has served to clarify many of the major issues. The first section summarises our reading of the current consensus. The arguments in it do not depend, by and large, on the more controversial questions surrounding the factors driving these imbalances – these are discussed in Section 2. In Section 3, we discuss the key choices facing Europe in preparing for and dealing with the eventual adjustment.

“Since 1997, the deficit has ballooned to unprecedented levels.”

1. WHAT WE KNOW

During the 1960s and 1970s, the US current account remained fairly close to balance. The chart below illustrates the substantial deficit that emerged in the early 1980s, but by the end of the decade the US external position had returned to around balance.

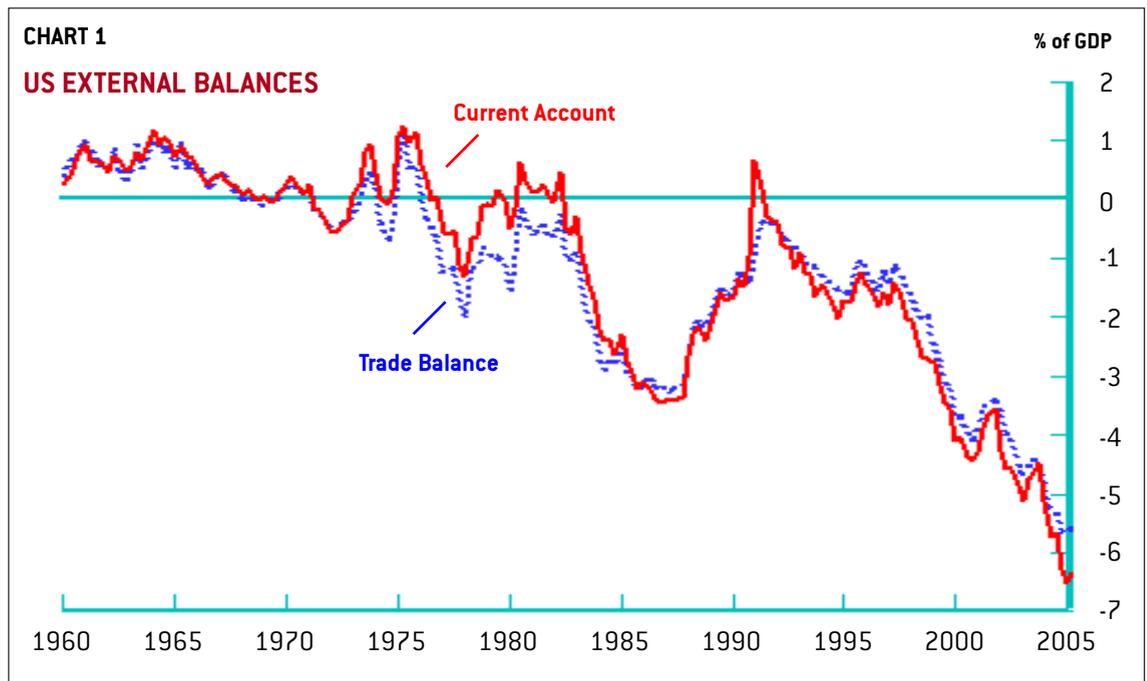
The first half of the 1990s saw the US run moderate current account deficits. Since 1997, however, the deficit has ballooned to unprecedented levels, driven by a dramatic deterioration in the trade balance. By the second quarter of 2005, the current account deficit had widened to 6.3 per cent of GDP and showed no signs of bottoming out.

To finance ongoing current account deficits, the US must borrow from the rest of the world. This adds to US net external liabilities,

which have risen from less than 3 per cent of GDP in 1990 to a forecasted 25 per cent of GDP in 2005.

In thinking about how the US external position will evolve going forward, several key points are widely accepted:

First, the trend of rising US net external liabilities relative to GDP cannot continue forever (see Box 1). As Herbert Stein, chairman of the Council of Economic Advisers under Presidents Nixon and Ford, famously remarked, “That which cannot go on forever won't.” A continuously rising ratio of net external liabilities to GDP would eventually see the burden of servicing these liabilities becoming unbearably large. Anticipating this, foreign investors will grow increasingly reluctant to continue to lend to the US even before this happens. Foreign investors may even retreat from lending to the US much earlier, if they regard the proportion of dollar assets in their portfolios as becoming too large relative to assets in other currencies.



Source: Bureau of Economic Analysis (BEA)



BOX 1:

SOME CURRENT ACCOUNT ARITHMETIC

At some stage, the ratio of net external liabilities to GDP must stabilise. It is reasonable to assume that the long-run rate of return on US net external liabilities roughly equals the long-run rate of growth of US GDP. It then follows that stabilisation in the ratio of net external liabilities to GDP requires that the US trade deficit eventually narrow to near zero.

As the current account also includes net interest payments on foreign liabilities as well as net transfer payments, a near-zero trade balance implies a moderate current account deficit. The precise size of this sustainable current account deficit depends on the level at which the ratio of net external liabilities to GDP eventually stabilises. In turn, this level depends on when the adjustment process begins.

Formally, growth in US net external liabilities can be described by the equation $NFL_{t+1} = (1+r)NFL_t + TB_t$, where NFL_t is the level of net foreign liabilities, r is the rate of return on these net liabilities, and TB_t is the trade balance plus net foreign transfers. Let x denote the growth rate of GDP, so that $GDP_{t+1} = (1+x)GDP_t$. Under the assumption that $r = x$, stabilisation in the ratio of net external liabilities to GDP at level d (that is, $NFL_{t+1}/GDP_{t+1} = NFL_t/GDP_t = d$) requires $TB_t = 0$ and $CA/GDP = -rd$.

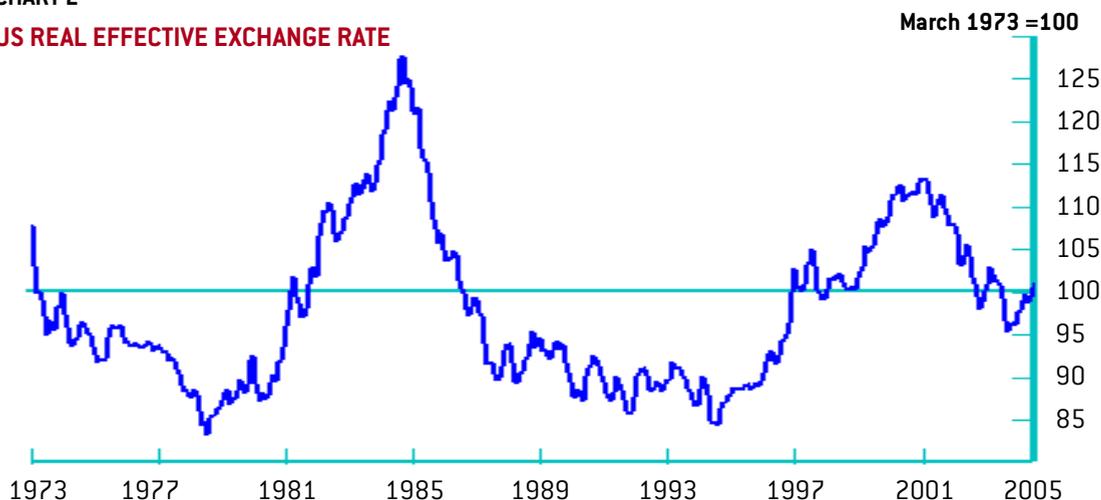
Second, US current account adjustment will almost certainly involve a significant real depreciation in the dollar. Given that the responsiveness of US exports and imports to changes in the real exchange rate is relatively small, substantial real dollar depreciation, perhaps in the range 20-40 per cent, will be required to shrink the US trade deficit¹.

Moreover, with US imports now 70 per cent larger than exports, exports need to grow at a rate nearly twice as fast as imports to prevent the trade deficit from widening further. In other words, the gap between imports and exports has grown so large that a dramatic acceleration in exports is necessary if exports are to catch up. In this regard it is telling that the 3 percentage point swing in the current account balance in the late 1980s came with a real depreciation of the dollar of 30 per cent (Charts 1 and 2).

Some have argued that a reduction in the US fiscal deficit can bring about current account adjustment without a need for dollar depreciation. This argument, however, ignores the fact

CHART 2

US REAL EFFECTIVE EXCHANGE RATE



Source: Federal Reserve Board

¹Estimates of the responsiveness of exports and imports are taken from Chinn (2005). Estimates of the amount of dollar depreciation that may be required to bring about adjustment are from Blanchard, Giavazzi and Sa (2005) and Obstfeld and Rogoff (2004).



	2000	2002	2004
Euro Area	1,845	2,237	2,961
Asia	1,219	1,567	2,421
Japan	750	940	1,373
China	172	270	434
Major Oil Exporters ¹	105	165	267

Source: BEA and US Treasury

	1995	2002	2005 ²
United States	-114	-475	-759
Euro Area	49	49	24
Asia	72	244	341
Japan	111	113	153
China	2	35	116
Major Oil Exporters ¹	8	92	398

Source: IMF

that the restraining effects of fiscal contraction on US imports would be only temporary. Moreover, the US Federal Reserve would respond to a cyclical downturn resulting from fiscal adjustment by lowering interest rates, thereby putting downward pressure on the dollar.

Third, the longer current account adjustment is delayed, the more pronounced will be the depreciation of the dollar. According to some estimates, if adjustment started today, a cumulative real decline in the dollar of roughly 30 per cent over the next three years would put the US current account balance on a sustainable path. If adjustment were delayed for a decade, however, a drop in the dollar of more than 50 per cent would be required³.

In the meantime, the rest of the world will continue to accumulate dollar assets at an unprecedented pace. Essentially all of these

assets are denominated or priced in dollars. A **fourth** key point is that when adjustment eventually occurs, holders of dollar assets in the rest of the world will suffer negative wealth effects. The rest of the world held about \$9,300 billion of gross dollar assets at the end of 2004. As shown in Table 1, the euro area's holdings amounted to nearly \$3,000 billion, equivalent to about one-third of euro area GDP. If

adjustment started today, depreciation in the dollar of 30 per cent would imply a loss of wealth for the rest of the world equal to nearly 10 per cent of rest-of-the-world GDP. The hit to euro area wealth would be of a similar order, relative to GDP.

These numbers assume an orderly adjustment. The wealth

effects of a disorderly correction would be even greater. Such a scenario would not only involve an abrupt drop in the dollar, but would also see surging US interest rates, falling US stock prices, and weaker economic activity in the United States. The effects would probably spill over into financial markets in other countries, dragging down asset prices in Europe and elsewhere.

The counterpart of the large and growing US current account deficit is a large and growing current account surplus in the rest of the world. As shown in Table 2, some of the largest surpluses in recent years have been recorded in Asia, especially in Japan and China. Surpluses have risen sharply in the major oil-exporting countries over recent years as a result of higher global oil prices. The euro area continues to run moderate current account surpluses.

The ongoing elevated level of global oil prices has shifted some of the rest of the world's current account surplus away from Asia towards net oil exporters. To the extent that the oil-exporting countries have lower propensities to save than economies in Asia, this shift may bring about a faster decline in savings in the rest of the world. As a result, current account adjustment may come earlier.

“Holders of dollar assets in the rest of the world will suffer negative wealth effects”

¹Norway, Venezuela, Algeria, Gabon, Nigeria, Kuwait, Saudi Arabia, UAE, Bahrain, Iran, Iraq, Qatar, Russia.

²IMF Forecast

³See Cline (2005)



2. WHAT WE DON'T KNOW

So much for what we know. What no one knows at this stage is when adjustment will begin and how fast it will be. It may begin soon or it may not start for quite some time. It may be sharp, causing large economic disruptions for the main trading partners of the US, or smooth, facilitating similarly smooth adjustments in their economies.

The burden of servicing its net external liabilities does not appear currently to be a problem for the US. Rates of return on both foreign assets and liabilities have been low over recent years, muting the effect on investment income of the excess of liabilities over assets. However, with US interest rates rising, and with a growing stock of external liabilities, US net investment income is projected to turn negative in the near future.

Similarly, there is little evidence to suggest that foreign investors are becoming satiated with US assets. Most countries in the world hold rela-

tively small, albeit growing, shares of their total portfolios in the form of US assets. We estimate that the US share in foreign portfolios is currently around 15 per cent³. However, US assets make up at least 40 per cent of global financial assets. In fact, the rise in the dollar over recent months strongly suggests that the US is facing few problems funding its current account deficit. This means that it may be some time before things turn sour. It is important to use this time effectively to prepare for a smooth adjustment.

“The US may just be supplying the assets that Asians want.”

“It may be some time before things turn sour. It is important to use this time effectively.”

How long can global current account imbalances continue? The answer to this question depends crucially on what factors are driving these imbalances. One view is that the US current account deficit reflects a large US capital account surplus, due to capital inflows from abroad.

This “capital-flows” or “global-saving-glut”⁴ view points to the high level of national savings abroad, especially in Asia, as the

factor responsible for the trade deficit. Asian countries seem hungry for dollar assets as they desire to rebuild - and even expand beyond - the net foreign asset positions they enjoyed before the financial crises of the late 1990s, in order to protect themselves against future financial turbulences and dependence on IMF support.

Furthermore, these countries face growing demographic problems. Given the absence of well-developed social security systems in most Asian countries except Japan, they may want to accumulate net foreign assets as a source of income for their rapidly ageing populations. If this is the case, the US is just supplying the assets that Asians want, and this arrangement could go on for some time with no need for an immediate, sharp adjustment. Eventually, however, the “capital-flows” view suggests that the US capital account will have to balance and the current account with it.

The alternative to the “capital-flows” view is that the US current account imbalance is driven by trade flows. Under this “trade-flows” view, the overvalued dollar and robust economic growth in the US relative to the rest of the world have boosted US imports and depressed US exports. This view differs from the “capital-flows” view mainly in that it suggests there is no reason why the rest of the world will continue to finance this deficit for an extended period of time. Under this view, therefore, the need for an

TABLE 3. 2004 BILATERAL TRADE BALANCE¹ (\$bn)

	EU	China ²	Major Oil Exporters
United States	-96	-162	-86
EU		-87	-82
China			1
Major Oil Exporters			

Source: BEA, Eurostat and own estimates.

¹A negative figure means that the region in the left-hand column ran a deficit with the region in the row.

²Includes Hong Kong.

³Based on Cline (2005).

⁴See Bernanke (2005)



adjustment in current account imbalances may arise soon and fast.

If global current account adjustment were to start today, a narrowing of the US trade deficit to about zero would imply a contraction of US net exports of roughly \$700 billion at an annual rate. The flip side of this adjustment is that the rest of the world's trade surplus with the United States would necessarily shrink by \$700 billion. As shown in Table 3 on the previous page, the US runs large bilateral trade deficits with China, Europe, and the major oil exporting countries. Europe's trade surplus with regards to the US of \$96 billion in 2004 was almost offset by Europe's \$87 billion deficit vis-à-vis China.

To get a feel for the magnitude of the adjustment, let us assume that the burden of adjustment is shared equally among Asia, Europe, and the major oil exporting countries. This would imply a decline in European net exports of \$233 billion, equivalent to about 2 per cent of EU-15 GDP.

As already discussed, the closing of the US trade deficit requires a depreciation of the real effective exchange rate of the dollar (a weighted average of bilateral real exchange rates). The key factor determining how the burden of adjustment is shared across countries will be movements in these bilateral exchange rates. It follows from this that:

“The benign scenarios for Europe depend on most of the adjustment occurring in the US and Asia; Europe can do little to make that happen.”

● The more the Asian economies remain hardnosed and peg their currencies to the dollar, the more the euro will have to appreciate and therefore the greater the deterioration in the European trade balance.

● If the Asian economies allow their currencies to appreciate, Asia's trade surplus would decline and relatively little of the adjustment burden might fall on Europe.

● A pick-up in investment or a decline in saving rates in Asia would reduce Asia's demand for US assets. Conversely, a pick-up in US national saving, by closing the budget deficit and increasing household saving, would reduce the US demand for borrowing from the rest of the world. Both would put downward pressure on the dollar and upward pressure on the Asian currencies, again perhaps with little effect on Europe.

● A switch in Asia from a dollar-dominated portfolio strategy to a strategy of buying euro assets would result in an appreciation in the euro and put a heavy share of the adjustment burden on the euro area economies.

Unfortunately, the benign scenarios for Europe depend on most of the adjustment occurring in the US and Asia; Europe can do little to make that happen.

3. KEY CHOICES FOR EUROPE & THE EURO AREA

In view of the inevitable adjustment, European policymakers face four key policy questions:

1. What exchange rate policy in Asia would be best for Europe?
2. Should Europe welcome the euro becoming an international reserve currency?
3. How can policy promote the smooth reallocation of resources?
4. What are the implications for monetary and fiscal policy?

CHINA'S EXCHANGE RATE POLICY

Since adjustment will involve depreciation in the US real effective exchange rate, the question arises: to what extent will governments in Asia allow their currencies to appreciate? Especially important in this regard is China's exchange rate regime.

China in particular has pegged its currency firmly to the US dollar for many years. In July 2005, the renminbi was allowed to appreciate about 2 per cent, and has been stable since. China's government announced that, in the future, it would peg to a basket of currencies, but the exact composition of this basket remains unspecified.

Future adjustments in China's exchange rate policy have two dimensions that are relevant for Europe. One is the level of the exchange rate. The more the renminbi is allowed to appreciate against the dollar, the larger the part of the US current account adjustment that falls on the trade flows between China and the US,



and the less need there is for adjustment between the US and Europe. The other dimension is the exchange rate regime. The more the Chinese peg shifts from the dollar to the euro, the more China will become a net buyer of euro assets. This is likely to result in a euro area current account deficit vis-à-vis China, and an appreciation of the euro's real exchange rate, thereby weakening euro area exports. Europe therefore has a clear interest in a significant appreciation of the renminbi against the dollar, but not in an increase in the euro's share in the currency basket to which the Chinese peg their currency.

RESERVE CURRENCY STATUS

A significant and lasting increase in the euro's share in the currency baskets that China and other Asian countries peg to, and in their asset portfolios, would certainly give a boost to the euro's position as a global reserve currency. The second key question is whether Europeans are willing to let that happen, given that it would imply large and lasting current account deficits of the euro area with regards to Asia as it absorbs the excess savings coming from that region. This question does not arise with the "trade-flows" view, because under that view there is no choice: the euro area's current account will move into deficit no matter what. Under the "capital-flows" view, it is an issue because European reactions to a decline in Europe's current account balance

will influence the attractiveness of euro assets for Asian investors. In the past, European governments have been quick to call for exchange rate depreciations in the face of current account deficits, fearing that such deficits might result in the loss of jobs in Europe.

"Europe therefore has a clear interest in a significant appreciation of the renminbi against the dollar."

The "capital-flows" view implies that closing the US current account deficit requires either an increase in US national savings, or a decline in Asian national savings, or that Asian countries switch from a dollar-dominated portfolio strategy to a strategy of buying euro assets. European policy can do nothing about the first two, but it can do something to make euro-denominated assets more attractive for Asian investors. Increasing productivity in Europe would be a step in the right direction.

Reserve currency status promises revenues resulting from the global use of a currency, but it would also expose the euro to potentially large and volatile shifts in the international demand for liquidity, which would result in higher exchange rate volatility. In the past, the Bundesbank was always reluctant to accept that. It is not clear whether the ECB will be more inclined to tolerate more volatility.

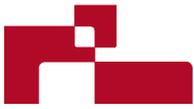
RESOURCE REALLOCATION

A third set of policy choices concern how to facilitate the reallocation of resources that real exchange rate adjustment will necessitate. Drawing on the example presented earlier, adjustment that would cause European net exports to contract €233 billion would result in more than 3 million job losses in Europe's traded goods sector. If these displaced workers were not able to find new jobs in the non-traded sector, the average EU-15 unemployment rate would jump to 9 per cent from 7.5 per cent today, increasing the fiscal burden of unemployment accordingly. To keep unemployment from rising, significant resources would need to shift from the traded goods sector to the non-traded sector. In order to promote a

"In order to promote a smooth reallocation of resources, policymakers in Europe need to do more to liberalise credit and labour markets."

smooth reallocation of resources, policymakers in Europe need to do more to liberalise credit and labour markets. In this regard, further liberalisation of the services sector is crucial.

These reforms would also help to boost potential growth in Europe. A lasting correction of global current account imbalances is likely to require an improvement in European potential growth, not just a cyclical pick-up of European growth above potential and an associated temporary boost to imports from the US. Stronger domestic demand in the form of business investment should also contribute to higher potential growth. Rising net



financial inflows into Europe, as net inflows to the US decline, would provide financing for this additional investment. Moreover, higher real consumption in Europe would have positive effects on European consumers.

FISCAL AND MONETARY POLICY
Finally, the real exchange rate is what matters for adjustment, but monetary policy can only have an effect for a limited period at best when prices are rigid. It is therefore not clear that the ECB should be taking any steps at present to address global currency imbalances, other than monitoring developments closely.

However, the ECB should stand ready to loosen monetary policy promptly and aggressively

should a sharp adjustment occur that threatens to result in deflationary pressures in the euro area. Even before that happens, the ECB should be open and clear about its determination to act promptly in order to prevent a risk of deflationary expectations emerging in the face of a significant weakening of the dollar.

A fiscal expansion in Europe can mitigate the effects of the decline in aggregate demand resulting from the US current account adjustment. But to facilitate this without endangering the sustainability of public finances in the

EU countries, governments should move their budgets to balance or small surpluses now.

An additional benefit of these sound policies would be to make European assets more attractive to Asian investors.

By following these recommendations, European policymakers will be taking out an insurance policy that will help Europe avoid a major downturn should the US experience abrupt current account adjustment. Prudent people buy insurance. Given the magnitude of the imbalances, policymakers in Europe need to act quickly.

“The ECB should stand ready to loosen monetary policy promptly and aggressively.”

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