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International Payments Imbalances

Jesus Felipe, Frank Harrigan, and Aashish Mehta

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International Payments Imbalances

The recent "global payments imbalances" have raised questions about their sustainability and how they can be resolved. Views on these issues are diverse. For developing Asia, the current account surpluses, positive savings-investment gaps, and reserve accumulation pose significant structural challenges: (i) investment rates in several countries are low by historical averages as well as when compared to assessments of needs; (ii) in the PRC, the current account surplus appears to reflect a glut of savings rather than a drought of investment; (iii) reserve accumulation points to the need for deeper and more efficient domestic and regional capital markets; and (iv) governments across Asia need to buttress social protection and insurance mechanisms to cope with possible future economic shocks.

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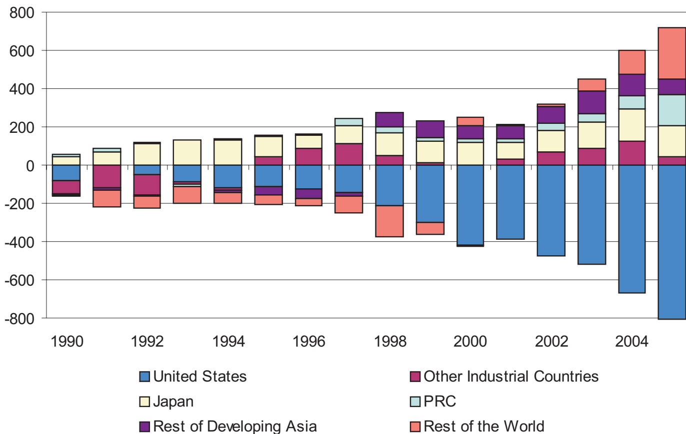
What are They?

Over the last few years, the term "global payments imbalances" has been used to refer to the growing current account surpluses/deficits between different regions of the world, together with a substantial accumulation of international reserves by several Asian countries. These trends have raised a number of concerns.

Figure 1 shows the current account balances of the different regions of the world for 1990–2005. The figure provides information essential for understanding the concerns surrounding imbalances. Until the mid-1990s the surpluses/deficits were relatively small. Starting in 1998, however, they began increasing quickly, and, as yet, they show no tendency to stabilize.[1] When current account surpluses/deficits are divided by world gross domestic product (GDP), as shown

Figure 1. **World Current Account Balance ($ billion)**



Source: *World Economic Outlook Database* (International Monetary Fund 2006c).

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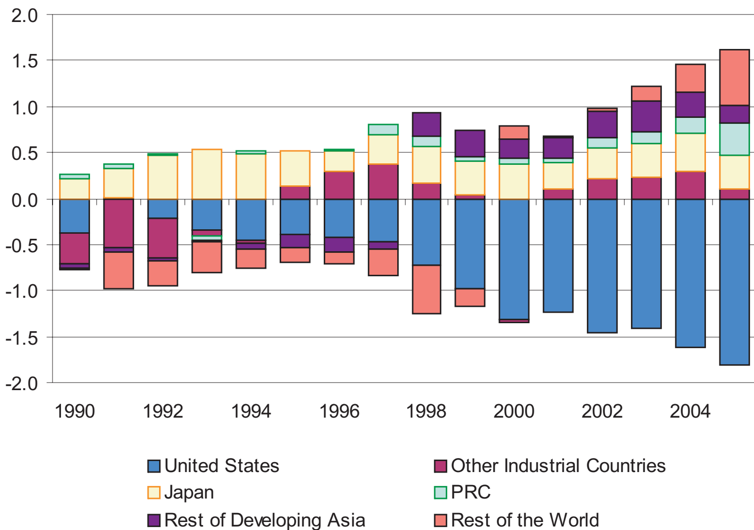
[1] Total surpluses/deficits do not add up to zero due to statistical discrepancy.

in Figure 2, a similar pattern is detected, that is, the imbalances still display no tendency to stabilize.

The United States (US) has had a current account deficit every year during this 16-year period, except in 1991. In 2004–2005, it represented more than 1.5% of world GDP. During this period, the deficit doubled, and in 2005 it represented 6.4% of US GDP (up from about 1.6% in 1996) or 1.80% of world GDP. On the other hand, Japan has consistently been in surplus. Between 1990 and 1997, except for the People's Republic of China (PRC), developing Asia (comprising the newly industrialized economies [NIEs], South Asia, Southeast Asia, the Pacific, and Central Asia) was in deficit. However, since 1997 the PRC has had a significant surplus. In 2002, the PRC had a current account surplus of $35 billion, but by 2005 this had soared to $159 billion, equivalent to 0.357% of world GDP (more than twice as much as in 2004). And the combined current account surplus of the rest of developing Asia reached $85 billion in 2005. Starting in 2003, the surpluses of the rest of the world (the combined surpluses of the Middle East, Africa, Latin America, Eastern Europe, and Russia) increased significantly to about $266 billion in 2005 (equivalent to 0.6% of world GDP), mostly due to significant oil revenues as a result

Figure 2. **Current Account as Percent of Global GDP**



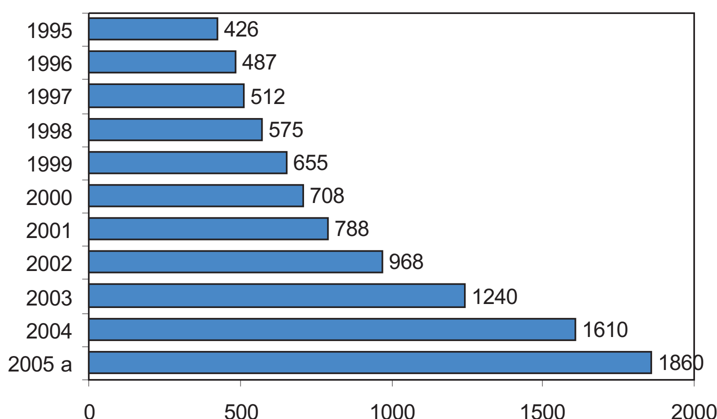
Source: *World Economic Outlook Database* (International Monetary Fund 2006c).

of the run up in oil prices over that period, surpassing total developing Asia ($244 billion). Today the group of countries with the world's biggest current account surpluses is not emerging Asia, but the oil exporters (almost $400 billion in 2005). In fact, the rise in oil prices explains half of the widening of the US current account deficit since 2003, a larger share than that accounted for by the PRC. These swings coincided with the increase in the US current account deficit.

Figure 3 shows the stock of foreign exchange reserves of developing Asia for 1995–2005. Capital flows to Asia have supplemented current account surpluses, leading to an expansion in Asia's foreign currency reserves. In 1995, the region had total reserves of $426 billion. By 2005, the stock had increased to $1.86 trillion, a difference of $1.43 trillion. A large (though not precisely measured) share of these reserves is reinvested in US dollar-denominated assets, mostly US Treasury bonds. These figures indicate that of the increase in reserves over this period, about 72% ($1.03 trillion) was accounted for by current account surpluses, while the rest was accounted for by capital account surpluses.

Up until 1996, many Asian countries had current account deficits, but positive net capital inflows more than compensated the deficits. An important part of these capital inflows was probably made up of

Figure 3. **Foreign Exchange Reserves ($ billion)**



Note: a means preliminary.
Sources: *International Financial Statistics* (IMF 2006b) and *Asian Development Outlook* database (ADB 2006a).

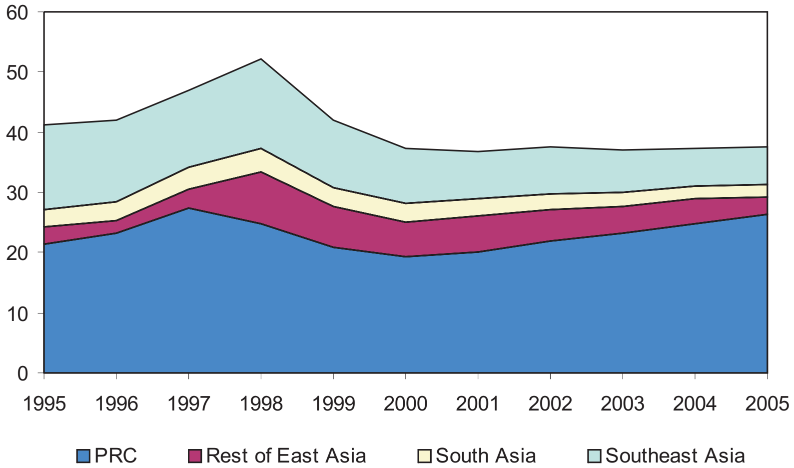
short-term speculative loans and portfolio flows. The Asian crisis and its immediate aftermath led to large negative outflows on the non-FDI (i.e., portfolio) capital account of many countries. Following a sharp depreciation of the real effective exchange rates, current account surpluses supported accumulation of international reserves. This situation continued for a number of years in countries like Indonesia, Malaysia, Philippines, Singapore, and Thailand. For Taipei,China, the late 1990s were marked by large current account surpluses and negative net capital flows. The current account surpluses, however, dominated the net capital outflows in most years, contributing to growing international reserves. During the last few years, it has enjoyed both current account surpluses and positive net capital flows. Hong Kong, China enjoys large current account surpluses, the major contributor to the increase in international reserves, but also large capital outflows, especially in 1998 and during 2002–2004.

From the mid 1990s through 2003, FDI was the main contributor to capital inflows in the PRC. These large inflows dominated the current account surplus. However, large non-FDI outflows led to negative capital accounts between 1997 and 2000. In 2001 and 2002, non-FDI outflows decreased substantially, with the consequence that FDI inflows dominated and made the capital account positive again, even eclipsing the current account surplus. Starting in 2003, non-FDI flows turned strongly positive as the PRC opened its equities market to foreigners. By 2004, portfolio flows, the current account surplus and FDI contributed strongly to the increase in international reserves, with the capital account overshadowing the current account.

Finally, Korea saw a strong recovery in net capital flows after 1998. This was caused initially by increases in both FDI and non-FDI flows (between 1999 and 2001). But starting 2001, non-FDI flows dominated the capital flows, although FDI recovered in 2004 (although the current account surplus dominated the capital flows). Thus, international reserves in Korea during this period increased due to both current account surpluses and net capital inflows.

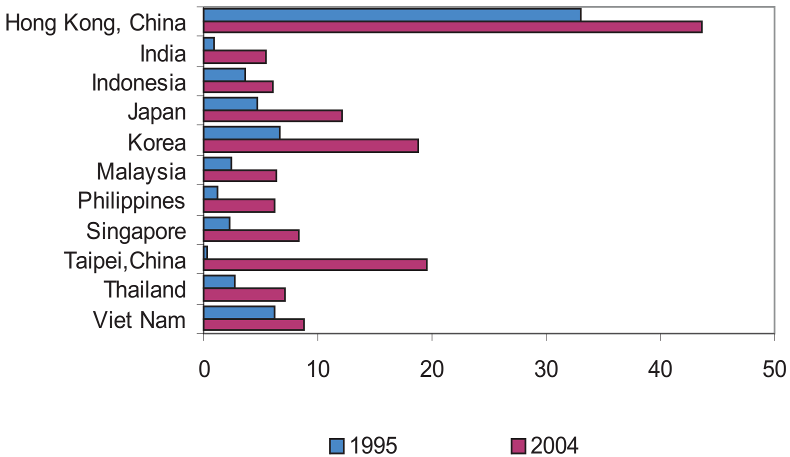
Figure 4 shows Asia's share in the US trade balance. The figure shows that Asia's share peaked in 1998, when it reached about 50%. Then it declined following the financial crisis, and remains at about 40%. While the PRC has an increasing share in the US trade deficit, the shares of the rest of developing Asia have declined. Figure 5 shows a significant increase in the share of developing Asia's exports bound for the PRC. This reflects increased trade in components within Asia, and the emergence of the PRC as an assembly point for final goods for export. A growing link between FDI and intraregional trade in Asia has been widely noted (ADB 2006a). While some of these foreign

Figure 4. **Developing Asia's Share in US Trade Deficit (percent)**



Source: US Census Bureau (2006).

Figure 5. **Share of Asian Exports Bound for the PRC (percent)**



Source: *Direction of Trade Statistics* (IMF 2006a).

investments are owned by Japanese and other Asian firms, many belong to US and European Union mother companies. The returns on such investments are linked to Asia's exports to the US and other industrialized countries.

Imbalances: A View from the Real Economy

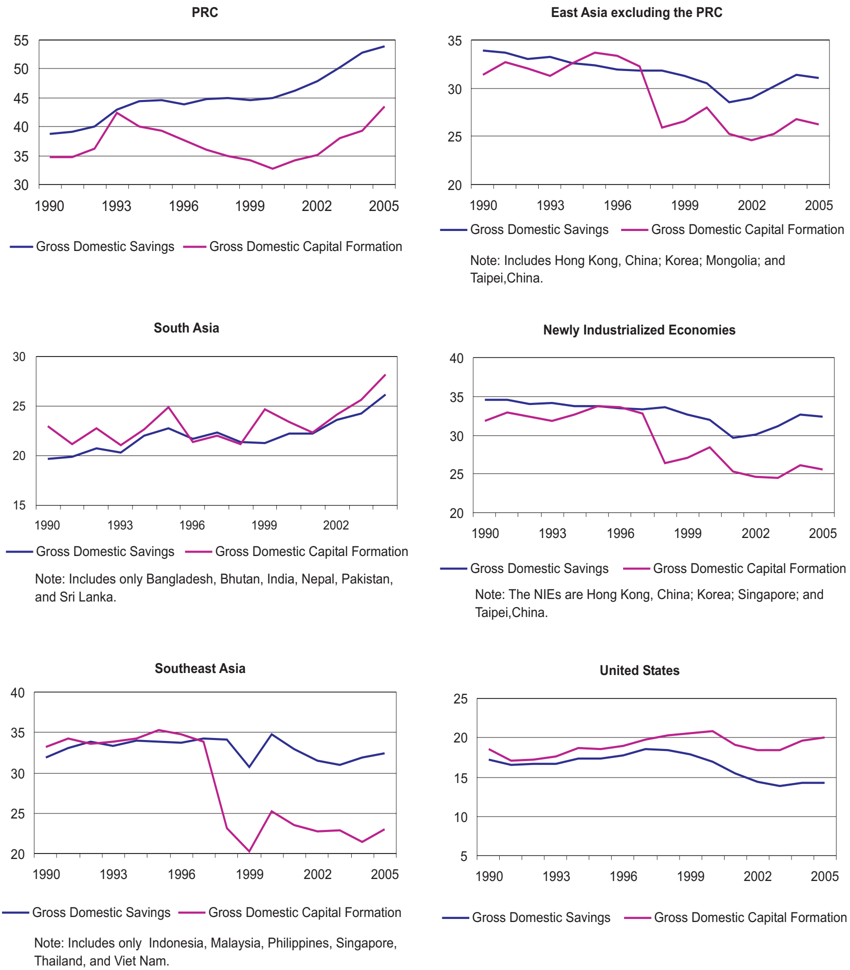
Another way of looking at imbalances is through the lens of savings and investment, the difference between which equals the trade surplus. Figure 6 shows that in Asia, with the exception of South Asia, savings has outpaced investment, while in the US, savings has lagged investment over a protracted period.

Two further features of Figure 6 are noteworthy. First, savings and investment rates in the PRC and South Asia have grown, largely undisturbed by the financial crisis of 1997. In the PRC, a large increase in savings has outstripped investment. Second, in the rest of Asia the difference between savings and investment grew after the crisis, because investment slumped, while savings only dipped slightly. These trends reflect savings-investment gaps in the private sector (Felipe et al. 2006). The public sector has often been in deficit. The total effect of these movements is an increase in the gap between savings and investment in developing Asia as a whole, following the Asian crisis. Possible reasons for the gap include overinvestment prior to the crisis, and residual excess capacity; a focus on repairing weak balance sheets and using profits to write down debts; and diminished expectations of profitability.

Meanwhile, US savings have fallen to 14.3% of GDP, while the investment rate remains stable at around 20%. This situation is driven by the fiscal balance, the federal portion of which moved from a balanced position in 1999 to a deficit of 4%[2] of GDP in 2005, as well as by household savings, which were –0.4% of household disposable income in 2005. While the fiscal deterioration is accounted for by a combination of defense spending, discretionary spending growth, and tax cuts, explanations for limited private thrift are varied. One key argument is that rising property values, fueled by low interest rates, create an the impression of growing wealth and obviate household savings. Seen through the lens of savings and investment gaps, imbalances reflect vigorous demand growth in the US, and domestic demand growth in Asia that has kept pace with output.

[2] This is the on-budget fiscal deficit, excluding the social security surplus.

Figure 6. **Savings and Investment in Asia as Percent of GDP**



Sources: *Key Indicators* database (ADB 2006b), *Asian Development Outlook 2006* (ADB 2006a), US Department of Commerce Bureau of Economic Analysis, (2006), and CEIC Data Company Ltd Database.

Imbalances, the Debate

The key questions regarding the imbalances are whether they are sustainable; and if they are not, how are they likely to be resolved. Views on these issues are surprisingly diverse. The orthodox and perhaps most commonly held view is that the imbalances constitute a potential threat to global economic stability. But people who agree on this also have different opinions about how adjustments will occur—whether they will be smooth or abrupt, whether they will involve predominantly movements in the real sector or the financial sector, the manner in which central banks will intervene, and the like. Set out below are highly stylized, and somewhat simplified, positions in this important discussion. The full views of the authors cited are inevitably more nuanced than this presentation allows, so references are provided.

(i) Imbalances present a clear threat to global stability.

Roubini and Setser (2004 and 2005), for example, argue that foreign creditors will eventually, and possibly suddenly, become unwilling or unable to continue financing the US current account deficit at low interest rates. This is largely because financing this debt requires them to bear all the risks of currency adjustments. Such a change of heart by creditors would possibly trigger a disorderly unraveling of imbalances. The authors concede that the US dollar's position as an international reserve asset could support demand for US dollar liabilities for some time, but postponement of needed adjustments would increase the cost of such adjustments.

Implicit in the Roubini and Setser view is the idea that financial markets will move first and that the real sector will follow. Financial markets are both volatile and prone to overshooting, so a financial sector-led adjustment could be bumpy.

(ii) Imbalances are problematic, but are likely to unwind more gradually.

There have been a variety of attempts to model imbalances (for example, Blanchard et al. 2005, Obstfeld and Rogoff 2004, and Caballero et al. 2006). The features of these models differ in significant respects, and there is considerable uncertainty about the strength of some of the key macroeconomic relationships that drive them. Some models imply that substantial revaluations of real exchange rates are

required to induce the adjustments in the real sector and in asset markets that would be needed to resolve imbalances. However, the range of estimates is wide, with some models (e.g., Caballero et al. 2006; see below) suggesting that adjustments are more likely to come through real interest rates, rather than exchange rates. Other authors, including Chinn (2004), provide empirical evidence that the relationship between the real effective dollar exchange rate and the US trade deficit is weak. In this view, the formation and resolution of trade imbalances is driven by differential growth rates across economies and by differences in the sensitivity of imports to income growth.

(iii) Imbalances are sustainable.

Yet other authors have argued that the imbalances are sustainable, either because they result from deliberate policies, or from long-term features of financial markets.

Dooley et al. (2004) suggest that imbalances arise from employment-generating, export-led growth policies in developing countries, especially the PRC. Even if this requires exporting country governments to finance the US trade deficit, they would still find such interventions sensible. Given the scale of the unemployment and underemployment problem facing developing Asia, this political economy calculus, they argue, is unlikely to change soon. DeLong (2006) argues that if continued sterilization of currency inflows into the PRC threatens to raise interest rates and harm employment generation, the People's Bank of China might permit the inflows to result in inflation instead. Likewise, the Bank of Japan might welcome modest inflation. Both outcomes would devalue the dollar in real terms, without sharp nominal exchange rate movements or adjustments.

Caballero et al. (2006) argue that the relatively poor quality of savings instruments in the rest of the world, and low growth in the EU and Japan push savings to the US, and drive US interest rates down. The attractiveness of US assets reduces the cost of financing the US current account deficit, reducing the required exchange rate adjustment.

(iv) Imbalances are smaller than they appear.

Hausmann and Sturzenegger (2005 and 2006) question the standard measure of the US current account deficit, and have reverse-engineered a new measure. According to their figures, the US does not run a current account deficit. They argue that the conventional

measure does not include US exports of liquidity (the use of the dollar as the currency of trade permits the US to earn seigniorage); insurance (US dollar assets are safer than the alternatives); and know-how embodied in US FDI. They label these elusive, but presumably enriching exports, “dark matter.” Several critics, including Buiter (2006) have criticized the new measure, and question the existence of much of this dark matter. However, even under the new measure, the current account surplus is diminishing.

Underlying Development Challenges for Asia

The idea that payments surpluses in Asia reflect a conscious effort to maintain undervalued exchange rates intended to boost economic growth through exporting does not sit comfortably with the empirical record. Yes, fast growth of exports has been an important feature in the successful development of a number of countries. But where exports have grown quickly, so too have imports, particularly of capital and intermediate goods. Also, where fast economic growth has been sustained, it has usually been supported by strong domestic demand, particularly investment (ADB 2005). Over time, there have been significant swings in the contributions of domestic and external demand to growth in developing Asia. A decade ago, developing Asia was a current account deficit region and surging domestic demand was priming debt.

Concerns with rapidly rising reserve accumulation are comparatively recent. But here, too, the facts do not readily support a mercantilist Asian export drive story (Genberg et al. 2005). Genberg and his colleagues make three points. First, the sharp run-up in reserves since 2001 has occurred in countries that have had widely differing currency regimes. True, reserves have risen sharply in Malaysia and the PRC and both pegged the value of their currencies to the US dollar (till July 2005), but reserves also climbed in countries with more flexible currencies including Japan; Korea; Taipei,China; Thailand; and Singapore. Second, since 2001 a significant portion of reserves have been accumulated through capital inflows, as well as through current account surpluses. Finally, outside of the PRC, current account surpluses have been associated with declining investment rates that are now low compared to their historical average, conditions not normally associated with undervalued exchange rates.

Decisions about monetary and exchange rate policy should be made on domestic considerations, with the aim of supporting price and broader macroeconomic stability, and with an eye to prudent

macroeconomic financial management. Greater exchange rate flexibility is welcome when it allows the authorities to pursue better these aims. The PRC and Malaysia have taken measured steps toward greater flexibility and now have greater discretion over the course of domestic interest rates. But a sharp revaluation of Asian currencies, which some have called for (e.g., Bergsten 2005), could pose dangers. Model experiments consistently show that an appreciation of the yuan and other Asian currencies would actually contribute little to the resolution of global payments positions (e.g., Lee et al. 2004, McKibbin and Stoeckel 2004, and Park 2005). And it would be difficult to judge at what point an appreciation could tip the region into deflation.

But lurking beneath Asia's rising current account surpluses and international reserves are significant structural challenges.

Outside of the PRC, recent current account surpluses in developing Asia are associated with investment rates that are well below historical averages (see Figure 6). Investment rates also appear low compared to assessments of needs. For example, ADB, Japan Bank for International Cooperation, and the World Bank (2005) have highlighted the vast gaps that exist in physical infrastructure provision in the region. If acute infrastructure constraints are not eased, they will eventually limit potential growth. These needs cannot be met from public sector resources alone, though much could be done to improve public sector revenue mobilization. Creative mechanisms are likely to be needed to bring public and private sector investors together to bridge financing gaps and to reduce the risks associated with projects that have very long payback periods.To make this happen, improvements will be needed in legal, regulatory, and financial systems. Strengthened governance will be crucial to most of these changes. To stimulate private sector investment, an improved business climate would certainly be helpful. Cumbersome and time-consuming business registration processes; burdensome tax and other regulations; corrupt tax and customs administration; difficulties in accessing credit; and poor quality public services, including infrastructure, can all constrain private investment.

In the PRC, current account surpluses appear to reflect more of a glut of savings rather than a drought of investment. The new Eleventh Five-Year Program foreshadows important shifts in government priorities that should help address stresses and emerging imbalances. For example, measures to redress disparities between the countryside and the towns should raise the contribution that domestic consumption plays in supporting growth. But the key to unlocking consumption demand and ensuring better quality investments will be reforms to the

banking and broader financial system that will guide the allocation of credit on the basis of market tests. Closing gaps in the provision of pensions and social protection, in which both the public sector and private sector have a role to play, would also dilute self-insurance motives and lower precautionary savings. The combined effect of these measures, and a gradual easing of demographic forces supporting saving, should help to boost domestic demand.

A second important challenge that fast reserve accumulation in developing Asia points to is the need for deeper and more efficient domestic and regional capital markets. Cross-border investment originating in Asia is still predominantly directed to the US and Europe, despite savings deficits in some parts of the region. Possibly this reflects an inadequate supply of profitable investment outlets. However, a weak domestic institutional investor base, information gaps, regulatory weaknesses, and shallow markets have added to the outflow and left central banks to play a prominent intermediation role. A more efficient use of surpluses will require determined efforts to deepen private sector participation in both domestic and regional capital markets. This, in turn, will require legal, regulatory and other institutional reforms, the success of which will hinge on improved governance. As markets develop, other mechanisms, such as special purpose vehicles, which have clear commercial objectives, may be able to put Asia's surplus savings to better use. But care needs to be taken to ensure these mechanisms do not become a reservoir for the growth of off balance sheet public sector liabilities. In tackling this difficult structural agenda and in addressing the risks posed by imbalances, regional cooperation initiatives will be important.

Last, but by no means least, the imbalances debate and heightened concerns about global economic stability serve as a timely reminder of the need to buttress social protection and insurance mechanisms, and the importance of public expenditure policies that are pro-poor, which provide adequate support for sustainable livelihoods for the poor and vulnerable. The reversals in poverty reduction and in other social achievements that followed in the wake of Asia's crisis just under a decade ago caution against complacency. Closer integration with the global economy has brought enormous benefits to developing Asia, but developing Asia must also recognize that as its international economic footprint gets larger, it has to play its role in required adjustments and should prepare for the possibility of global economic shocks. Equally, developing Asia's leaders need to have their say on global imbalances and other important international issues. This will require more inclusive mechanisms to facilitate dialogue, policy coordination, and governance at a global level.

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