The Instability of the Global Current Account Imbalance

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Abstract

Dooley et al. (2003) have argued that today’s international financial system has structural similarities with the earlier Bretton Woods (1946 – 71) arrangements and is stable. In this paper I review the key facts in the International Monetary System in the last decade to analyze the stability of what Dooley et al. have called “Bretton Woods II”, which describes the current fixed-exchange rate and export-led growth model of some Asian countries, including China. This paper argues that the Bretton Woods II is imbalance and unstable. The imbalance leads to financial fragility and deterioration in the world’s economic activities and in the absence of international macroeconomic policy cooperation, the collection can take the form of hard landing instead of soft landing.

Key Words: Global Imbalance; Global Current Account Imbalance; Financial Instability; Bretton Woods II
1. Introduction

During the last decade a large number of scholars in academia, private sectors and research institutions have expressed their concern with regard to the global current account imbalance. Such a crucial situation is integrated as the simultaneous external balance of US current account deficit and emerging market economy surpluses. This situation is known as the global current account imbalance. Even though the global financial crisis in 2008 and worldwide recession have led to a recessionary adjustment of imbalances in current accounts across deficit countries with sharply falling imports (led by the United States) and a plunge of export earnings in most surplus countries.

However, as the global financial crisis abates and global growth tentatively recovers, the risk of a substantial further widening of the imbalances also rises. In most surplus countries, especially those in developing Asia, growth continues to rely heavily on exports and high savings rates, leading to relatively weak domestic demand and high reserve accumulation. In the major deficit countries, particularly the United States, private savings have increased as consumers have become more cautious, but not adequately enough to cover widening current account deficits. The U.S. current account deficit has risen back quickly in 2010 and is expected to be wider increase in 2011. From this perspective, I would like to argue that we are in the midst of a difficult situation; the global current account imbalance is unstable. The fundamental cause of the economic bubble and world financial crisis 2008 is the negative side effect of the global imbalance. Thus, the effort to significantly narrow the global current account imbalance could be a plausible solution.

This paper critically assesses the global current account imbalance. The remainder of the paper is structured as follows. A brief description of the feature of the global current account imbalance will take place in section 2. Section 3 briefly outlines key characteristics of the Bretton Woods System 2, which is explained by DFG. The several debates of the Bretton Woods System 2 will be discussed. Finally, the paper is concluded in section 4.

2. Global Imbalance

The global economy has been accumulating large and widening imbalances in recent years. The crucial feature of such imbalance is the large U.S. current account deficit and the surplus of many countries of the world, mainly emerging countries in East Asia and commodity-exporting countries (Eichengreen and Park 2006:1; Ocampo 2007:2). The U.S. current account deficit increased rapidly from $416 billion in 2000 to $640 billion in 2004, to $810 billion in 2006 (around 6% of GDP). Although, the U.S. demand for imports fell sharply between 2008 and 2009 after the sub-prime mortgage crisis, bring the U.S. current account deficit down, the narrowing of the current-account deficit in the

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1 Throughout this paper the term ‘global current account imbalance’, ‘global imbalance’ will be used interchangeably.

2 The U.S. current-account is the broadest measure of U.S. international trade in goods and services, receipts and payments of income, and net unilateral current transfers (such as gifts).
United States since the eruption of the financial crisis has mainly been driven by a sharp downward adjustment in household consumption and residential and business investment, as well as by an increase in household savings (UN, 2010). However, the U.S. current account deficit has rebounded quickly from $378 billion in 2009 to $470 billion in 2010 and is expected to widen again. (See figure 1).

Meanwhile, the large current-account deficit of the United States is matched by an aggregate of surpluses in a number of other countries. Figure 2 provides the information of the current account surpluses of emerging countries in East Asia and commodity-exporting countries. Emerging market economies are running current account surpluses (particularly emerging Asia and the oil exporters) and the surplus money from these countries has flowed back to finance the U.S. current account deficit. Some economists believe that the money inflow kept the U.S. interest rates lower than they might have been in the absence of it.

**Figure 1: Current-Account Balance and Its Components**

Source: Bureau of Economic Analysis. U.S. Department of Commerce

**Figure 2 Current-account balance, 2004-2010**

Source: UN (World Economic Situation and Prospects 2010)

Note: Data 2010 has been updated by author
Not surprisingly, the global current account imbalance has been the issue of intense debate in academic and policy circles. To shed light on the global current account imbalance it is useful to review the recent debates of this issue. Some argue (Chinn and Ito 2005; Roubini and Setser 2004; 2005a) that the main reason for the increase in U.S. current account imbalances is the decline in U.S. savings, especially fiscal deficit and private sector savings deficit at low interest rates, since 2002. In other words, the huge deficit of the United States is interpreted as being the result of American households’ decision to consume more than they could afford.

In contrast, Bernanke (2005, 2007), Clarida (2005a, b), and Hubbard (2005) argue that global imbalance does not come from the United States. ‘A global saving glut’ which is an excess saving from Asian emerging market countries, driven by rising savings and collapsing investment in the aftermath of the Asian financial crisis, is the cause of the U.S. current account deficit. From this view, the U.S. external imbalance is a problem come from aboard and amenable to a solution only in the longer term, as better developed financial systems mitigate this excess savings problem.

In regard to this debate, there is less agreement as to what the main reason of the global imbalance is; it is difficult to say which argument is correct. For now, what we can say is that if the world community intends to reduce the global current account imbalance, the U.S. needs to save more; and the Asian emerging market countries, especially China, needs to import and consume more so as to lower their trade surplus. Unfortunately, the determination and cooperation efforts from these countries are too weak to make this thing happen. So the global imbalance is still the most prominent feature of the contemporary international monetary and financial landscape.

It is important to note that the influential series that is able to explain the global imbalance is the Bretton Wood II concept, which has been proposed by Michael Dooley, David Folkerts-Landan and Peter Garber (hereafter DFG). According to the argument from DFG (2003, 2004a, 2007) they indicate that there is no problem with the global imbalance and this system is stable. They explained that in the Bretton Woods system, Europe and Japan fixed their currencies to the dollar; in the last decade, the Asian economies and most emerging market economies have contributed a new Bretton Woods system of pegs to the dollar (BWII). The emerging market economies- starting with China and others in Asia- formally and informally tie their currencies to the dollar to maintain weak exchange rates for current account surpluses, and achieve export-led growth and industrialization.

DFG have also argued that this system of fixed and heavily managed exchange rates is fundamentally stable. The intervention required to prevent Asian currencies from appreciating will continue to provide the large of the financing the US needs to maintain current account deficit. For the periphery countries, the benefits maintaining weak exchange rates exceed the costs of reserve accumulation. China, for example, relies on export-led-growth to absorb hundreds of millions of workers from its rural areas.

3 Please see Eichengreen and Park (2006); Chinn and Ito (2005)

Reserve accumulation by Asian and other central banks allowed the United States to rely on domestic demand to underpin its growth and finance its current-account deficits.

For DFG, they really believe that this imbalance and distortion is fundamentally stable, and will continue until the China's development model changes. More recently, based on their BWII hypothesis, they argued that the BWII will continue longer because other emerging economies have pursued an export-led growth model. The DFG argue that every country has rational calculations and are willing to maintain the distortion.

However, there are actually many critiques in the DFG’s argument. Some economists such as Roubini and Setser (2005), Roubini (2006), and Hunt (2008) have argued that this structure is unstable. They claimed that the size of the financial flows required to finance U.S. current-account deficits will increase at a faster rate than the willingness of the world’s central banks to accumulate dollar reserves, eventuating in a collapse of the system. While, Palley (2006) argues that there are many theoretical reasons for believing in intervention to protect the target exchange rate; foreign exchange markets are prone to herd behaviour.

For Eichengreen (2007) believes that the international monetary system has changed considerably from 1960s. He noted that in the past there was no major alternative currency to challenge the U.S. dollar as the international reserve currency. And also the European countries that formed the periphery constituted a cohesive bloc; under the new structure the dollar faces a strong alternative in the euro and the countries of the Asian periphery tend to act in a heterogeneous way. The factors that differentiate the present system from the earlier structure suggest, therefore, Eichengreen argues that the present system will collapse.

Furthermore, some economists have critiqued the DFG’s concept is misleading. For instance, Goldstein and Lardy (2004, 2005) pushes us to think harder and deeper about the DFG’s argument that Foreign Direct Investment to China contributes to the build-up of a highly-efficient capital stock that would otherwise be unattainable in that country because of inefficiencies and distortions in the domestic financial system. They have argued that foreign investment in China has funded about 5 per cent of fixed asset investment in China in recent years. This was very small a share to offset the alleged misallocation of investment financed through China’s domestic banking system. Meanwhile, Truman (2008) and Goldstein and Lardy (2008)’s argument that the exchange-rate policies in many Asian economies, including that of China, have made more flexible exchange rates than assumed by DFG.

Moreover, some well-know economists, such as Roubini (2004), Rajan and Subramanian (2004), Eichengreen (2004, 2007), Rodrik (2006), Goldstein and Lardy (2004, 2005), and Ferguson and Schularick (2009) have taken the paper seriously enough to cite it, they have argued that DFG underestimated the costs of sterilization in China and other Asian economies, especially those associated with financial repression. To be more precise, when many Asian countries and China tie their currencies to the dollar and intervene in the forex market to maintain weak currencies, it means that they have to buy the dollar and sell their nation currency.
However, by doing this there are negative side effects, for instance, to maintain the exchange rate, China’s central bank steps in and buys all those excess dollars at a fixed rate, and accumulate them as official reserves. Normally all that new RMB would accelerate inflation, due to more money chasing the same amount of goods, which leads prices to go up. In order to prevent that, the Public Bank of China (PBOC) has to ”sterilize” its foreign exchange (FX) purchases by taking that same amount of RMB back out of the economy, usually by forcing banks to hold higher reserves or by selling them special government bonds. In effect, the PBOC has to use its tightening tools just to counteract the loosening effect of its FX purchases, and keep the money supply from exploding. When it buys dollars with RMB, it amplifies the money supply, which would lower interest rates. In order to keep interest rates from falling it has to cancel that effect by starting to raise reserve requirements or selling bonds. If it actually wants to raise interest rates, it has to surpass that breakeven threshold by selling even more bonds or hiking reserve ratios even higher. Maintaining the currency peg exceeds the bar for what actually set monetary tightening — anything below full sterilization falls short, and even though it may look like tightening, is actually net loosening.5

In short, although there are many critiques of the Bretton Wood II concept, it seems clear to me that the BWII has not ended. The BW II is likely the most successful in showing the picture of the global current account imbalance. As we know later regarding the argument of Eichengreen (2007) that the dollar faces a strong alternative in the euro and the countries of the Asian periphery tend to act in a heterogeneous way is quite not right. The dollar is still functioning as the world reserve currency. More than that, the recent paper of Roubini (2008) accepts that the BWII is not demise as he argued in his paper with Brad Setser (2005); Roubini (2007). He wrote in recent paper that “it is true that BW2 is still alive as the massive ongoing reserve accumulation by BRICs, GCC and emerging markets suggests”. Even the world financial crisis 2008 has been expected to be the end of the BWII system, but when the world economy is recovering the basic structure of the international monetary system does not alter.

However, one thing need to be cleared, this global imbalance is not stable as DFG claimed, the international economic distortion lead to various negative side effects, and also without policy adjustments cooperation, and coordination between East Asia and the US, the imbalance will not go away. Next, this paper will show why the global imbalance is unstable.

3. Global Imbalance and its unstable

During the past decade the world economy has shown remarkable instability. The root of the world economy instability is the large and chronic U.S. current account deficit

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5 (See Patrick Chovanec 2011). It should be noted that it is difficult to trace how much the central banks intervene in the forex market, and also difficult to find when they do. However, Niall Ferguson (2010: 9-11) shows the data of China’s reserve accumulation compare with current account and capital account of China from 1990-2008, he claimed that the data is irrelevant, it means that the authorities of China intervene in the currency market to prevent a stronger currency. (See also, Roubini, N 2007; Roubini, N. and B. Setser 2005a)

6 (BRICs =Brazil, Russia, India and China); (GCC= Gulf Cooperation Council is a political and economic union of the United Arab Emirates, Bahrain, Saudi Arabia, Oman, Qatar and Kuwait)
and the capital inflows from the surplus countries to finance the United States deficit i.e.
the global imbalance. The global imbalance reflects excessive money supply in the United
States through loose macroeconomic policies. This lack of the stable dollar money supply
which undermine the confidence in the dollar as the reserve currency. It should be noted
that because the U.S dollar functions as the nation currency and international currency
simultaneously it is the most important reason for the global economic instability. People
consider commodities as an asset class, so the lack of confidence in the dollar clearly is
one such general cause for the surge in commodity prices.

In order to end the U.S. current account deficit the dollar must depreciate which
would lead to a decrease in imports and an increase in exports. Ferguson and Schularick
(2009) argue that the current account imbalances of the past decade were to a large
degree a function of exchange rate undervaluation and will not be resolved automatically
without major exchange rate adjustments. While, economist Paul Krugman (2007)
estimates that the dollar would need to depreciate by at least 35% from its 2005 value in
real terms in the long run for the trade deficit to be reduced to zero. At the same time,
tight monetary policy needs to be used to reduce domestic demand. By doing this, it is
expected that the global imbalance would decline.

Unfortunately, these things would not happen, many counties avoid the appreciation
of their currencies by pegging their currencies to the dollar, run current account surplus
and achieve export-led growth model. The dollar’s fall over the 9 year period of 2002-
2010 was moderately paced at about 3% annually, which is too small of a number for
decreasing U.S trade deficit (Elwell, 2011). Moreover, after Dot Com crisis the Fed
intended to pull the U.S. economy out of recession, therefore, the Fed decided to use the
low interest rate policy for many years. It is, of course, low interest rate lead businesses to
borrow more, expanding investment and consuming expenditure in both financial
sectors and real sectors. Not surprisingly, it contributed to a widening of the current-
account deficit and also increased an enormous U.S. money supply to the world
economy.

It should be mentioned, however, that even the dollar money supply has rapidly
increased in the last decade due to the U.S current account deficits, loose monetary and
fiscal policy but the price level is stable. Therefore, Ben Bernanke and his economist
fellows explain that in the past 25 years economic landscape has declined in the volatility
of output and inflation; they have dubbed this remarkable decline the “the Great
Moderation”\(^7\). In his 2004 speech on the Great Moderation, Ben Bernanke highlighted
three hypotheses on the cause of the Great Moderation: 1) structural change; 2) improved
macroeconomic policies; 3) and good luck.

He explained that the structural change in economic institutions, technology,
business practices, or other structural features of the economy have improved the ability
of the economy to absorb shocks. The increased depth and sophistication of financial
markets; deregulation in many industries; the gradual shift away from manufacturing

\(^7\) See Bernanke, B., 2004, "The Great Moderation," Remarks at the Meetings of the Eastern
Economic Association, Washington D.C.
toward services; and increased openness to trade and financial liberalization has led to the macroeconomic flexibility and stability. The second is the improved performance of macroeconomic policies, particularly monetary policy. The historical pattern of changes in the volatilities of output growth and inflation makes us believe that better monetary policy may have been an important contributor to increased economic stability.

Ironically, it is clear that the Great Moderation hypothesis is wrong, in the last decade; it is not the Great Moderation, but the Great Bubble and followed by the Great Crisis. These global current account imbalances and distortions have been threatening to global economic activities. The global imbalance and the enormous increasing of the U.S. dollar money supply has created economic overheating, commodities bubble; real estates bubble; and the stock markets bubble, followed by the world financial crisis. This is because the owners of the dollar debt- let say, China, India and some oil- and raw material producing countries- are increasing unwillingness to hold dollars, and looking for a highest return (Soros 2008: 82, 2009; Roubini, and Setser 2005a; Perelstein 2009: 15; Bibow 2010)

To be clearer, people have been worried about the value of dollar. The more they accumulate wealth in term of dollar asset the more they are concerned about their wealth from the increasing U.S money supply. As we have learned from the history of international money, when using a national currency as international currency it leads to a tension between national monetary policy and global monetary policy and also when the international money supply increases or decreases instability it has transferred the impact to the functions of the international money and the world economy activities. In regard to the global imbalance, people are concerned with the value of dollar, so they diversify their reserve and saving by holding in other assets.

The history of international money, the world economy, and capitalism have never been like this. The distortion and the chronic U.S. current account deficit, government budget deficits, and loose monetary policies have been flooding the global financial market with the dollar. There is more U.S dollar money supply in the world capitalism than what it needed. As a result, this phenomenon has sent the real-estates, stock markets, oil, gold, and other commodities prices beyond their fundamental value, accelerated speculation, and created the world commodities, real estates and stock markets bubble. The data shows the house price index of the material rich countries, the major commodities price index, and the important stock markets index, most of them soared in the same pattern since 2002 until the bubbles burst.

Figure 3 shows the data of house price index of the material rich countries during the global imbalance period. In this time, the global imbalance period, the house price index of material rich countries has soared in the same pattern, with suddenly dropped between 2008 and 2009, and then increased gradually after 2009.
It is important to emphasize that the house prices in the United States was the main bubble, figure 4 provides the data of U.S. house price percentage change year over year from 1996 to 2007. Adjusted for inflation the real U.S. house prices rose 34% in the period 2000-2005 (not adjusted 51 %) which is more than double any five-year rate in the past 30 years.

Not surprisingly, many borrowers refinanced their mortgages quickly. The rising of house prices improved households credit profiles, therefore, one could borrow on better terms than before. While, financial institutions have developed and designed many new financial instruments such as the collaterized debt obligations (CDOs), mortgage products special designed, Subprime Mortgage-Backed Securities, adjustable rate mortgages (ARMs), ARMs with “teaser rates”, many foreigners were holding these mortgage-based securities. So when the subprime crisis triggered, the impact of contagion effects was worldwide. (Getter et al, 2007).

Some scholars, particularly Keynesian economists explain that these complicated financial products and the increased sophistication of speculation technique as well as the lack of “proper financial regulation” are the cause of economic bubble. However, we have to understand that before the economic boom the situation of the world economy was imbalanced. This imbalance increased enormous international liquidity and has sent oil, gold, real-estate and other commodities prices beyond their fundamental value. This situation accelerated speculation and created an economic bubble; the new financial instruments and the lack of proper financial regulation is the aftermath of the global imbalance.
Furthermore, over the past decade the global imbalance has created a distortion and led to record prices for oil, gold, minerals, and other commodities (see, figure 5, 6 and table 1). Between 2002 and 2008, oil prices rose more than 320%, gold price rose more than 400% and food prices by 138%. Following the sharp drop in commodity prices in late 2008 (except gold), prices for most commodities rebounded sharply in 2009 and is continuing their upward trend in 2010. There are many factors for the soaring of the commodities price, but, one of most important reason is because the side effect of the global imbalance circumstance.
The global imbalance and distortion has also created the super bubble in stock markets. After 2002 the “important stock markets” has moved in the same pattern, figure 7-10 shows the pattern of the soared and fall of the “important stock markets”. It should be noted that the stock markets index around the world also rose and fell in the same pattern during the imbalance period.

Source: UN-DESA
Figure 7 United States Stock Market Index (Dow Jones Industrial)

Source: TradingEconomics

Figure 8 Euro Area Stock Market Index

Source: TradingEconomics

Figure 9 Japan Stock Market Index

Source: TradingEconomics

Figure 10 Hong Kong Stock Market Index

Source: TradingEconomics
Table 2 provides the data of the world stock market capitalization, in the end of 2002 the world stock market capitalization was just 22,834,052.6 million U.S. dollars, but it has increased rapidly to 60,874,399.3 million U.S dollars in the end of 2007. In only 5 years the world stock market capitalization increased about 38 trillion U.S dollars. On the other hand, the world stock market capitalization fell sharply between 2007 and 2008 after the sub-prime mortgage crisis from 60,874,399.3 million U.S dollars to 32,551,432.8 million U.S. dollars, or it fell about 28 trillion in one year. More than that, one year later (2008-2009) the world stock market capitalization jumped sharply from 32,551,432.8 to 47,782,552.3 or about 15 trillion.

<table>
<thead>
<tr>
<th>Year</th>
<th>World Stock Market Capitalization</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>End 2001</td>
<td>26,904,918.0</td>
<td>---</td>
</tr>
<tr>
<td>End 2002</td>
<td>22,834,052.6</td>
<td>-15.2%</td>
</tr>
<tr>
<td>End 2003</td>
<td>31,202,299.9</td>
<td>36.6%</td>
</tr>
<tr>
<td>End 2004</td>
<td>37,168,428.0</td>
<td>18.7%</td>
</tr>
<tr>
<td>End 2005</td>
<td>40,974,050.0</td>
<td>11.2%</td>
</tr>
<tr>
<td>End 2006</td>
<td>50,791,661.1</td>
<td>22.3%</td>
</tr>
<tr>
<td>End 2007</td>
<td>60,874,399.3</td>
<td>19.9%</td>
</tr>
<tr>
<td>End 2008</td>
<td>32,551,432.8</td>
<td>-46.5%</td>
</tr>
<tr>
<td>End 2009</td>
<td>47,782,552.3</td>
<td>45.5%</td>
</tr>
<tr>
<td>End 2010</td>
<td>54,884,583.2</td>
<td>14.9%</td>
</tr>
</tbody>
</table>

Source: World Federation of Exchange

Note: Asia-Pacific total region excludes Osaka SE and NSE India to avoid double Counting with Tokyo SE and Bombay SE respectively. Data combine the main and alternative/ SMEs market Capitalizations.

In this perspective it is no exaggeration to say that this system is not stable. The global imbalance has created large international money supply, and set the scene for increasingly risky speculative operation in stock markets. This has led financial volatile and deterioration in the world economic activities. This is also not surprising that there are those who benefit from this bubble. Unfortunately, when the stock markets, commodities and foods bubbles have been created, just only a few people enjoy the benefits of the bubble. But when the bubble burst, the majority of people have to suffer, especially poor people in the poor material countries. At this stage it is sufficient to summarize that the global current account imbalance has created the enormous dollar money supply; this led to the decline of the confidence in dollar, and has created the inflated assets prices, and also global economic instability.

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4. Conclusion

The global current account imbalance is unstable. The large current account deficit and the large accumulation of debt make the U.S. dollar unsustainable in the long run and unattractive to invest; it is also create an expectation of a depreciate in the dollar exchange rate value. The global imbalance would obviously have negative spillover effects on financial markets and the global economy. The global current account imbalance has created the commodities, real estates and stock market bubbles. This has led financial fragility and deterioration in the world's economic activities. Therefore, it is important to recognize the DFG’s argument, that the distortion and global imbalance is stable is a very loose argument, and it is an unrealistic assumption. The economic distortion couldn’t continue forever, the global financial crisis and the world economic recession in 2008 insisted this truth.

Even the world economy is recovering, but the danger of falling into stagflation cannot be underestimated for many “important countries”. The recovery is also still vulnerable, more than by anything else, the global current account imbalance still the most prominent feature of the world economy, a little has been done for the adjustment, the side effect of the global imbalance is sending to the gold, oil and food prices. Sooner or later consumers, producers or governments and central banks will no longer be able to perform at the level of exaggerated expectations because hiking oil and food prices cut deeply into the budgets of consumers, appreciating currencies send current account balances into unsustainable deficit, or stock prices lose touch with any reasonable profit expectation. To sum up, the global imbalance is unstable, and in the absence of international macroeconomic policy cooperation, the collection can take the form of hard landing instead of soft landing.
References


