Global imbalances and the US current account deficit

BENGT PETTERSSON

The driving forces behind the large and persistent saving imbalances around the world are numerous and complex. They stem from the strong development of emerging-market economies as well as from the United States. The risk of abrupt adjustments that have very negative effects for the world economy has been discussed for a long time. An abrupt adjustment cannot be ruled out and many economists therefore view such a scenario with concern. But there are also arguments that the development to date is not indicative of any genuine imbalances but is being driven by households and firms looking ahead and for the greater part making rational decisions in efficient and globalised markets.

Summary

The growing regional current account surpluses and deficits are often referred to as "global imbalances". The US current account deficit has increased rapidly in recent years and the 2005 figure was over 6 per cent of GDP. Rising wealth in the United States has contributed to a fall in household saving, while the increase in corporate liabilities in the early 2000s was connected with high investment. Other factors have been decreased public sector saving in the early 2000s, high potential growth and a greater dependence on oil compared with other countries. The US current account deficit has much of its counterpart in surpluses in a number of Asian and oil-producing countries, characterised by restrained investment and high saving. A part of these surpluses has been invested in the US bond market and the capital inflow has contributed to low US long-term interest rates, thereby stimulating consumption. The inflow can be said to have financed the US current account deficit.

The epithet "global imbalances" implies that the situation is not ultimately sustainable. It can indicate that households and firms have based consumption and investment decisions on irrational grounds. Some economists therefore consider that the adjustment which many see as inevitable will be abrupt and entail major negative effects for the global

economy. But there are many arguments in favour of the situation being less vulnerable and that corrections will not be a problem. When the US current account deficit underwent an adjustment in the latter half of the 1980s, this did not have any clearly negative effects on the global economy. Since then, moreover, global free trade has expanded, international financial markets have been deregulated and globalisation has continued to accelerate. This means that, compared with twenty years ago, financing investment and consumption with foreign loans is much more feasible. The free movement of capital and greatly increased access to information reduce the risk of the type of abrupt financial market corrections, triggered by untenable capital controls, that occurred earlier. There are grounds for arguing that the players in the world economy for the greater part have acted rationally. Stabilisation policy has been improved throughout the world, not least in the United States, and inflation is historically low. Developments in recent years have also increased the probability that an adjustment of the global imbalances will be gradual. Public saving has risen rapidly in the United States, growth has picked up in Japan and the euro area, and China's exchange rate policy shows signs of greater flexibility.

Global imbalances

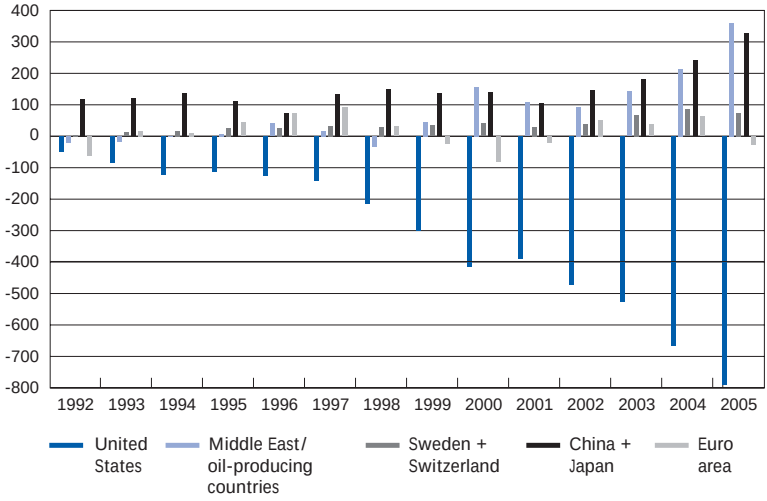
The US current account deficit is matched to over 95 per cent by the surpluses in China, Japan, a number of oil-producing countries and some small open economies such as Sweden and Switzerland (see Figure 1).[1] In the euro area the balance of trade fluctuates around zero.[2]

The expression "global imbalances", which is used in this article as a generally accepted description, implies that sooner or later there will have to be an adjustment to levels of assets and liabilities in the global economy that are sustainable in the longer run. However, there are instances of countries running a current account deficit for considerably longer than

[1] For countries that produce and export oil, a rising oil price has tended to strengthen the current account. In these countries, public saving has increased markedly because governments have been cautious about using the oil revenue for domestic investment and consumption; in most cases a large part of the surplus from oil has been invested instead in state-owned oil funds and the US bond market. Switzerland's current account surplus comes in part from the financial sector, not least the export of banking services. The largest of the other positive contributions to the global current account come from a number of emerging market economies in Asia. Due to measurement problems, however, a compilation of the national current accounts does not sum to zero. Starting from the balances for developed economies and emerging market economies as reported in IMF World Economic Outlook, September 2006, Tables 27 and 28, the global balance for 2005 was –61 billion US dollars, which is equivalent to not quite 8 per cent of the US current account deficit.

[2] Inside the euro area, however, the picture is not uniform, with large surpluses for Germany and the Netherlands and deficits for France, Italy, Portugal and Spain.

Figure 1. Current account balances for some countries and regions 1992–2005
USD billion



Note: Middle East/oil-producing countries refers here to the Middle East, North Africa, Norway, Russi and Venezuela.

Sources: IMF International Financial Statistics, IMF World Economic Outlook September 2006, May 1998 och Russia's Central Bank.

has been the case in the United States.[3] Deregulated international capital movements and increased free trade suggest that such an adjustment will not be abrupt.[4] So one cannot rule out the possibility that the imbalances will continue for a long time to come.

CAUSES OF THE IMBALANCES

The following identity can serve as a starting point for analysing what lies behind the growing US current account deficit:

$$CA = HS + BS - (G\text{-}T), \qquad (1)$$

where CA = current account balance, HS = household sector net saving, i.e. saving less investment, BS = business sector net saving, and $(G–T)$ = government sector net saving.[5]

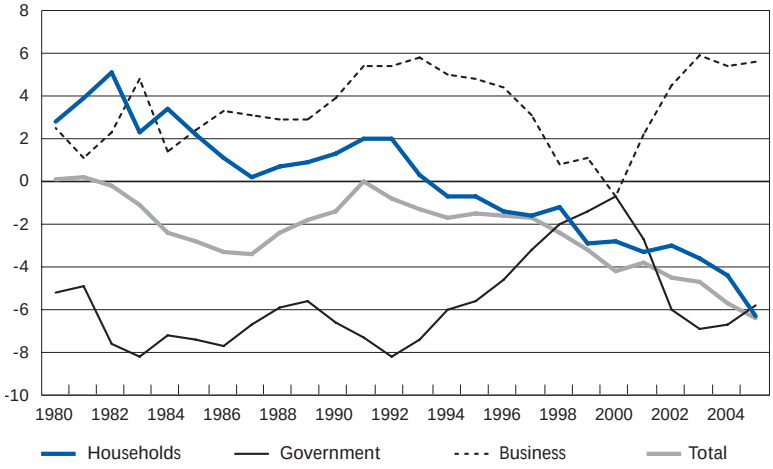
---

3 According to the statistics in OECD Economic Outlook 79, June 2006, there have been deficits in Australia since 1973 (average 4.1 per cent of GDP), in New Zealand since 1973 (5.4 per cent), in Greece since 1975, which for Greece is as far back as these figures go (5.1 per cent), in Mexico since 1988 (2.7 per cent) and in the United Kingdom since 1984 (2.0 per cent). Besides these instances, a number of new EU member states have had sizeable deficits for the past ten years or more.

4 Arguments for this are presented further on in this article.

5 Note that government net saving as considered here is not commensurate with what is normally meant by the public finances and budget balances. Net saving refers here to net government saving vis-à-vis the rest of the world. The difference is partly due to how development assistance, remission of developing countries' debt and defence expenditures abroad are booked. For 2005, government net saving in terms of the contribution to the current account amounted to –5.8 per cent of GDP, while the government sector's consolidated budget balance stopped at –3.7 per cent of GDP.

Figure 2. Household, business and goverment net saving as countributions to the US current account balances 1980–2005
Per cent of GDP



Source: OECD

Figure 2 shows how components of the US current account balance have developed in terms of this identity in the past quarter century.

The current account deficit's rising trend since the beginning of the 1990s comes in part from a fall in household saving. Moreover, business net saving decreased in the 1990s in connection with rapidly rising investment. The developments in the private sector were partly offset by increased government saving. Business net saving then rose dramatically during the economic slowdown in the early 2000s; firms curbed expenditure on investment and labour, accompanied by rising business income as government tax cuts stimulated household consumption. Meanwhile, the government finances deteriorated. In recent years, however, the government finances have improved considerably in connection with strong economic growth, while business net saving has stabilised at a high level. Household net saving has, however, continued to decrease, probably as a consequence of rapidly growing wealth.

It would be wrong, however, to explain the development of the US current account solely in terms of domestic factors. The deficits naturally have their counterparts in surpluses on average in the rest of the world. The US deficit can be said to be financed with other countries' saving surpluses that are invested in US bonds. Demand for bonds has pushed long-term interest rates down and that has helped to sustain the high demand in the US economy. Ongoing globalisation has made it increasingly possible to produce goods and services in low-cost countries for subsequent consumption in, for example, the United States. As long as these global market participants find the situation satisfactory, adjustments will not be abrupt.

An important aspect of the increased global imbalances in recent years is the sharply rising price of oil. This has affected foreign trade both directly, with a negative impact on net oil importers' current account, and indirectly depending on the extent to which a country has benefited from the oil producers' demand for imports. A broader picture of the factors behind the US deficit can be obtained by rewriting identity (1) as:

$$CA^{USA} = S^{USA} - I^{USA} = I^{RW} - S^{RW} \tag{2}$$

where S and I are national saving (private + public) and national investment, respectively. This identity states that the US saving deficit must be matched by a saving surplus in the rest of the world (RW).

The large US current account deficit is evidently a consequence of a number of interrelated factors, external as well as domestic. The factors that are usually mentioned are considered in more detail below. As discussed there, these factors tend to involve both sides of a coin – a surplus in one country/region has its counterpart in deficits elsewhere. The account therefore largely amounts to a description of different aspects of a particular issue.

LOW US SAVING (S^{USA}) AND HIGH SAVING IN ASIAN AND OIL-PRODUCING COUNTRIES (S^{RW})

When the US current account deficit increased in the 1990s, the government budget was improving (see Figure 2). This is explained by stricter budget discipline and the introduction of an expenditure ceiling, combined with decreased household saving and rapidly rising private investment. Domestic demand was stimulated by interest rates that were low because the Federal Reserve was able to keep its policy rate down thanks to strong productivity growth and low inflation expectations.

In the early 2000s an expansionary fiscal policy contributed to the continued increase in the current account deficit. Tax cuts and rising government expenditure helped to boost consumption and generate rising imports. However, the relationship between the budget balance and the current account balance is relatively weak because decreased public saving often makes up for increased private saving and vice versa.

In recent years the budget balance has been substantially improved by rapidly rising tax revenue in connection with the strong economic growth. Even so, the current account has continued to weaken.

The low national saving reflects low household saving, which partly has to do with greatly increased financial and real wealth in the form of equity (see the next section) and residential property. Housing policy has

probably been a major factor behind the decline in household saving in recent decades. Particularly in the past two decades, this policy has favoured home ownership (the "home-owner society"). Home ownership has spread as a consequence of the financial sector's deregulation in the 1980s and the introduction of new forms of borrowing, giving more and more households access to credit. An increased demand for owner-occupied dwellings has probably contributed to the increase in house prices that, via additional mortgaging, has tended to stimulate consumption. It can be argued that many households perceive home ownership, not as consumption but as a form of saving. Maintenance, repairs and extensions increase the value of a component of wealth that has been growing rapidly for a long time. In the national accounts, however, this is largely treated as households' consumption of services.

Another factor behind the low saving, at least in the past ten years, has probably been households' confidence in the future. Expectations that economic growth will continue to be favourable have strengthened beliefs in a stable labour market and further increases in real disposable income. Households have therefore been willing to bring forward some of their consumption. Low long-term interest rates have also stimulated household consumption and another factor behind their optimism is probably that a very large proportion of house mortgage rates are fixed for thirty years.[6] An interest rate increase does, of course, hit new borrowing, while decreased demand for housing and more subdued house prices put an end to the expansionary effect on consumption. But it is perhaps more important that even if interest rates rise rapidly, a very large proportion of borrowers are protected from increased interest costs. It can therefore be argued that for households in general, the overall effect of an interest rate increase may be smaller than many believe. In recent years the high oil price has subdued households' optimism about the future but a falling oil price has broken this tendency.

The future path of household saving in the United States is difficult to predict. But one argument in favour of increased saving is the uncertainty about the long-term problems of financing the public pension system and the deficit on corporate pension commitments. Another argument is the negative wealth effect that would be the case if the significant downturn in the housing market, which has occurred during the last year, were followed by a weaker trend growth in house prices than before. Up to now the negative wealth effects due to the development in the housing sector have been compensated by a strong development of equity prices. But any changes in saving behaviour will probably not be rapid.

---

[6] For 85–90 per cent of households, interest rates are fixed for thirty years, with a right to renegotiate loans at a cost that is low in this context.

Turning to the regions with a current account surplus, saving is generally high in Asia as well as in oil-producing countries. This applies mainly to private saving in the emerging-market economies in Asia and to Japan. A probable reason for the high saving is uncertainty about future public-financed pensions for an aging population. In China, saving has risen rapidly in the transition from a centrally-planned economy to more of a market economy. One explanation could lie in precautionary saving by households in order to be able to finance future costs for education, health care and pensions in a situation where, for various reasons, the social welfare system has more or less fallen apart. Looking ahead, however, there are arguments for a future decline in private saving in Asia as the emerging-market economies mature and populations age.[7]

A large proportion of the increased saving in Asia, as well as in other countries with a current account surplus, has been invested in US bonds. The return has been high in relation to the low risk.[8] Moreover, the American financial market is very liquid and diversified.[9] A wide range of instruments is available for investors who want to adjust their risks. This means that the US market is very likely to provide investors with what they are looking for. The strong demand for bonds is probably a major factor behind the low long-term interest rates in the United States.[10] Exchange-rate interventions by Asian central banks with a view to countering an appreciation of their currencies have led to dramatically increased foreign reserves in recent years. China aimed for exchange-rate stability in order to underpin its underdeveloped domestic financial sector. This has also probably been a component of the policy for economic growth geared to exports. In the past year or so, China's exchange-rate policy has been more flexible and some effective appreciation of the renmimbi has been tolerated. The increased foreign reserves, particularly in China, can also be seen as a way of building up a buffer against the possibility of future economic crises. The investments can be said to have helped to finance the US current account deficit. However, the share of global saving that is invested in the United States is still relatively small, which should mean that there continues to be room for increased external portfolio investment in the United States.[11]

The oil-producing countries' current account surplus has grown as a consequence of the rising price of oil. From the low of $9 a barrel for Brent Blend at the end of 1998, the oil price rose to almost $40 in 2004

---

7 See the analysis on p. 11 in Eichengreen (2005).
8 See e.g. Mann (2002) p. 131.
9 See Mann (2002) p. 141.
10 See Bernanke (March 2005).
11 See Mann (2002) p. 145.

and over $50 in 2005. A high of almost $80 a barrel was reached in August 2006, since when the price has fallen markedly. A part of the oil revenue in recent years has been reinvested in the production of oil but saving and the current account surplus have still increased rapidly. Today, the oil-producing countries around the Persian Gulf have current account surpluses that average around 30 per cent of GDP,[12] accompanied by budget surpluses that average over 20 per cent of GDP. There are indications that a large proportion of the oil sector profits in these countries has ultimately been invested, as in the case of Asia, in the US bond market. This, too, has probably exerted a downward effect on American long-term interest rates.

Large amounts of capital have accordingly flown from Asian and oil-producing countries to the United States. For a long time now the net capital flow to the United States has approximately matched the current account deficit. So to date the rest of the world seems to have had a strong propensity to invest in US assets. If saving in Asia were to decline, for instance because welfare systems are built up, there are arguments that point to a rising trend for long-term interest rates in the United States. However, such an effect can take a long time to materialise.

HIGH US INVESTMENT (I^{USA}), LOW INVESTMENT IN ASIAN AND OIL-PRODUCING COUNTRIES (I^{RW}) AND EXCHANGE-RATE POLICY IN ASIA

Investment in the United States in the 1980s and 1990s, particularly in the IT sector, led in time to major positive effects on productivity that were accentuated by business reorganisation and internal training.[13] Many firms were obliged to make these changes to cope with the strong competition in the United States. The flexible labour market there probably facilitated the process. In the period 1996–2005 annual productivity growth averaged 2.2 per cent[14] compared with the historical average of 1.4 per cent for the period 1961–95. It is noteworthy that during the economic slowdown at the beginning of the 2000s, this productivity growth slackened only marginally. The high productivity growth has been accompanied by a persistently rapid expansion of employment. Labour supply has increased, partly due to substantial labour immigration, much of it probably in the form of young entrepreneurs. The statistics on immigra-

[12] See "Summary Appraisal, Gulf Cooperation Council Countries", Institute of International Finance, August 15 2006.

[13] See e.g. Brynjolfsson (2003) and Van Ark, McGuckin and Spiegelman (2005).

[14] According to internationally commensurate OECD statistics in EO79, output in relation to the number in employment. According to US Bureau of Labor statistics, based on output in relation to the number of hours worked, annual productivity growth in the period 1996–2005 averaged 2.8 per cent.

tion show that in the aftermath of the terrorist attacks in September 2001, net immigration has not slackened. The OECD[15] estimates a potential growth rate of 3.2 per cent for the United States in 2007[16] compared with 1.9 per cent for the euro area and only 1.5 per cent for Japan.

If US economic growth exceeds the average rate for its main trading partners, it can be argued that it is natural for imports to rise faster than exports and for the current account deficit to grow.[17] A reasonable assumption is that these differences in potential growth will not change all that quickly. Even though some progress has been made, the process of reform to strengthen potential growth in Europe and Japan is on the whole proceeding slowly. Meanwhile, there continues to be confidence in the workings of the US economy and in a potential growth remaining high.[18]

Given that growth in the United States is likely to remain above the average for the main trading partners in the future, income in the United States will also presumably continue to rise faster than in major parts of the world. In that case, persistently strong growth and increased incomes could finance rising interest expenditure on foreign debt.[19] Even if debt grows because US investment is funded with external loans, the returns are sufficient to finance the interest expenditure. US net investment income will then remain positive and the net investment position stable.[20] Another aspect of importance for potential growth is that the improved productivity growth led to expectations of a high return on investment in American assets. That contributed to a capital inflow that strengthened the dollar and subdued net exports. It was also a factor behind the rising stock market, increased household wealth and long-term income expectations. Together with developments in the housing market, these factors have tended to weaken household saving. The Federal Reserve considers that the high trend for productivity growth is the single most important factor behind the current account deficit.[21] There has been a fall-off in

---

15 See OECD EO79, June 2006, Table 21. A picture compiled with alternative methods might differ somewhat from the result with the OECD's methods, which are designed to permit comparisons between countries. However, the potential differences are most probably only marginal. It is evident that for a long time growth in the US economy has been higher than in the euro area and Japan without leading to higher inflation.

16 We have chosen 2007 to illustrate potentiai growth in the medium term with the economy close to equilibrium. According to OECD statistics, the output gap is only slightly positive (actual output is slightly above the potential level) in that year. See Table 10 in EO79.

17 This is not always entirely self-evident, however. As a proportion of imports consists of intermediate items for exports, imports follow exports relatively closely, at least in the short run.

18 There are indications that US potential growth is currently lower than a couple of years ago. Productivity growth has slowed. It can also be argued that the growth of labour supply will slacken in the years ahead as the baby-boom generation retires. Note, however, that even when allowance is made for these effects, US potential growth will probably be considerably higher than in, for example, the euro area and Japan.

19 See the analysis in Engel (2005).

20 See the reasoning in Engel (2005).

21 See the analysis in Ferguson (2005).

productivity growth in recent years but most observers assume that it will remain favourable in the future.[22]

In Asia, the investment ratio fell steeply in connection with the financial crisis there in 1997. Since then the ratio has recovered but is still historically low. China is an exception, with notably rapid investment growth. One explanation for the low investment ratio in Asian countries apart from China is that it reflects a natural correction of an earlier investment bubble. The Asian crisis was preceded by warnings from various quarters that a number of the large ongoing investment projects, above all in the public sector, would presumably generate a low return. At least a part of the correction is probably attributable to this. Another explanation for the low investment ratio in many Asian emerging-market economies is a major lack of developed markets for corporate bonds. As long as these circumstances continue, investment in Asia apart from China will probably remain subdued.

THE HIGH OIL PRICE

The high price of oil in recent years has also contributed to the global imbalances; it accounts for as much as one-third of the deterioration in the US current account balance in the past six years. In 2005, for example, the high oil price accounts for 2 percentage points of the US current account deficit of over 6 per cent of GDP. Besides its direct negative effect on foreign trade, the oil price has worked indirectly in that the United States has benefited from just a very limited part of the oil-producing countries' increased demand for imports.[23] The direct effect of the high oil price is a consequence of the United States being both a large net importer of oil and more dependent on oil than other countries.[24] The oil-producing countries have, of course, generated a lot of revenue from oil and invested some of it in their domestic economies, for example to build up production capacity.

Asia is the region where exports to oil-producing countries have expanded most. Europe has also been relatively successful. One explanation for the latter may lie in Europe's proximity to both the Russian and the Norwegian market, as well as to markets in the Middle East compared with the United States. Moreover, there are signs that Europe and Asia

---

[22] OECD EO79, Table 12, for example, indicates that in the coming years annual productivity growth in the total economy is expected to average 2.1 per cent. That is clearly above the historical average but on a par with the rate in the past ten years.

[23] So-called petrodollar recycling.

[24] The very marked dependence on oil was underscored, for example, in President Bush's address to the nation in February 2006. In terms of consumption per capital, the United States is the world's most oil-dependent country.

produce products which match requirements in, for example, the Middle East. Looking ahead, there are clear indications that oil-producing countries are planning a massive growth of investment to expand production capacity and improve productivity. The investment projects, which are in various stages of implementation, total as much as USD 1000 billion.[25] If these investments are made, they could contribute, at least in time, to downward pressure on the oil price, while lower domestic saving in the oil-producing countries would reduce their current account surplus.[26] In addition, increased domestic investment in those countries would entail less demand for US bonds, leading to an upward effect on American long-term interest rates and a downward effect on growth. All else equal, lower growth in the United States can be said to imply more subdued import growth and higher net exports. In this way, increased domestic investment in oil-producing countries could lead to decreased global imbalances.

THE REAL EXCHANGE RATE AND COMPETITIVENESS IN THE UNITED STATES

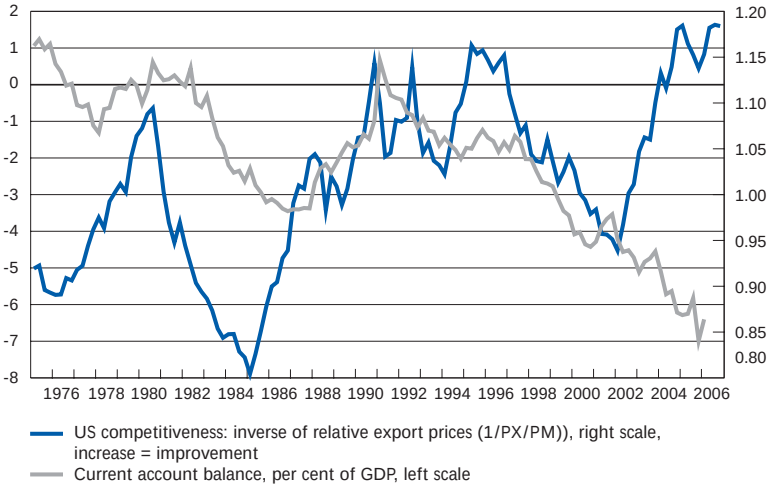
As the current account includes foreign trade in goods and services, its development might be expected to be closely bound up with competitiveness. A weakening of the dollar, for example, stimulates exports and subdues imports. Competitiveness can also be seen as an endogenous variable, so that decreased total saving in the economy leads to a deterioration of both the current account and competitiveness. Competitiveness can be impaired if a stronger increase in consumption leads, via higher inflation, to higher interest rates relative to the rest of the world and thereby to an appreciation of the dollar. There are situations, however, where the causal relationship between the exchange rate and the current account balance may be the reverse. A marked weakening of the current account can give rise to expectations of a need for an adjustment via the exchange rate. From time to time, this has been the case with the US current account deficit. The relationship between competitiveness and the current account has been relatively stable for the United States for a considerable time. An exception has occurred in the past three years, when an improvement in competitiveness, here in terms of relative export

[25] Note that this does not include some oil-producing countries, for instance Russia, where substantial oil investments are also planned, and Norway. See "Summary Appraisal, Gulf Cooperation Council Countries,", Institute of International Finance, August 15 2006.

[26] See the forecast for 2007 in "Summary Appraisal, Gulf Cooperation Council Countries,", Institute of International Finance, August 15 2006.

prices,[27] has not resulted in an improvement in the balance on current account (see Figure 3). There may be a number of explanations for this, for instance that competitiveness is now less important than it used to be for foreign trade. Another possibility is that it now takes longer for improved competitiveness to lead to a better development of exports. If so, one could expect a positive effect on the current account balance in the future.

Figure 3. US competitiveness and current account balance
Per cent



Sources: OECD EO79 and US Department of Commerce.

SENSITIVITY BETWEEN US GROWTH AND IMPORTS IS GREATER THAN IN THE REST OF THE WORLD

A number of studies[28] have shown that a given change in income affects imports to the United States more than to most other countries. This means that even if economic growth were the same in every country, the US current account balance would still weaken. It indicates that the US current account deficit has a structural component. With a few occasional exceptions, imports have exceeded exports for the past sixty years. Some possible explanations could have to do with the average age of the population being lower in the United States than elsewhere (imported goods tend to be more in demand among young people) and with the high labour immigration to the United States (many immigrants maintain their preferences for goods from their former home country).[29]

---

[27] Competitiveness can also be measured in terms of the real effective exchange rate; in principle this is the same as relative export prices.

[28] E.g. Hooper, Johnson and Marquez (1998) and Mann (2002) p. 138.

[29] See Mann (2002) p. 139.

As we have seen, there are many probable explanations for the large US current account deficit. It must then be asked whether the situation is sustainable in the longer run or whether an abrupt adjustment is to be expected.

Is the US current account deficit an "imbalance" and is US debt too large?

In the past, a favourable development of exports and avoiding a current account deficit have been among economic policy's primary objectives in Sweden and some other countries. In Sweden, attempts have been made to improve the competitiveness of export producers by writing down the currency. Government budget statements have frequently mentioned "balance in foreign payments" as a central policy goal.[30] A current account surplus has been considered desirable and a deficit ominous on account of the attendant foreign debt.

Today, however, there are a number of arguments against referring to increased current account deficits and surpluses in the world economy as global imbalances. With well-developed financial markets, decisions by households and firms are based on expectations of the future. Financial markets have become more efficient and widened the possibility of financing consumption and investment with loans. It may be asked why a current account surplus should be preferable to a deficit. If a country borrows to finance real investment in, for instance, advanced technology and thereby paves the way to higher growth and welfare, a current account deficit is clearly not a problem. Households that aim to smooth consumption over time and count on markedly increased income in the future can then also, in the light of growing wealth, for instance, finance consumption with loans without this constituting an imbalance in saving.

There are arguments in favour of the US current account deficit being more sustainable than many previously believed. With deregulated international financial markets and increased free trade, today it may be possible to run large saving deficits for longer than before capital markets were deregulated in the 1980s.[31] Twenty-five years ago, considerably less flexible financial markets would have ruled out the financing of invest-

---

[30] Swedish government budget statements in the 1970s and 1980s frequently mentioned "balance in foreign payments" or "eliminating the current account deficit" as a goal in itself. On the other hand, a target for the government finances was seldom considered. This is particularly clear in Finance Minister Gunnar Sträng's draft budget for fiscal 1976/77 (see page 8 of the summary). The message was much the same in the 1980s, although in the light of a budget deficit at 5 per cent of GDP in the draft budget for 1984/85, Finance Minister Kjell-Olof Feldt did refer to the need for budget consolidation. The Swedish krona was devalued a number of times. The goal for stabilisation policy can be summed up as "reasonable price stability". The policy entailed galloping inflation, weak government finances during long periods and a standstill in growth and welfare.

[31] See e.g. IMF, WEO, April 2005 and Cooper (2005).

ment and consumption to the extent that can now be arranged by borrowing abroad.[32] For a long time, US households have therefore been in a position to save less when the expansionary development in the housing market contributed to increased consumption. Another aspect is the wider range of financial instruments today. Previously, countries were more obliged to resort to increased saving in order to finance an expansion of production capacity. The coin's other face is that increased facilities for investing abroad have made it easier for countries where saving is high to place it in assets in other countries. Home bias (the tendency to invest in the domestic market rather than abroad) has decreased markedly. It can be mentioned, for example, that aggregate global portfolio holdings of foreign equity rose just from 1997 to 2001 from a little more than 20 per cent to over 35 per cent.[33] Investment in bonds and other instruments likewise shows clear signs of decreased home bias. If countries in Asia are interested in investing their saving surpluses in US assets, there is nothing to prevent them doing so. Free capital movements and considerably greater access to information reduce the risk of the earlier type of abrupt financial market corrections that stemmed from unsustainable capital controls.

The term imbalance suggests that markets are imperfect and/or that behaviour is not rational. The grounds for this are to a major extent weak. US households are admittedly characterised by low saving and increased debt but the value of their assets has increased even more and thereby their welfare. Saving among Chinese households is high because, when the social safety-net has disintegrated in practice, they are concerned about financing future costs for education, health care and pensions. Under the circumstances, that can also be seen as rational behaviour. If private behaviour is rational, what about those who decide economic policy? Have there been failings in economic policy that have contributed to the current account deficit? In the early 2000s US economic policy was highly expansionary (see Figure 4) and it might be argued that it did play a part in the current account deficit. In terms of the change in the structural budget deficit and in the Federal funds rate, the stimulus was the strongest since the 1960s.[34] Still, it is hard to conclude that stabilisation policy was unduly expansionary. Notwithstanding the strong stimulus from economic policy (plus the very high oil price in recent years), long-term inflation expectations have remained at a low level, long-term inter-

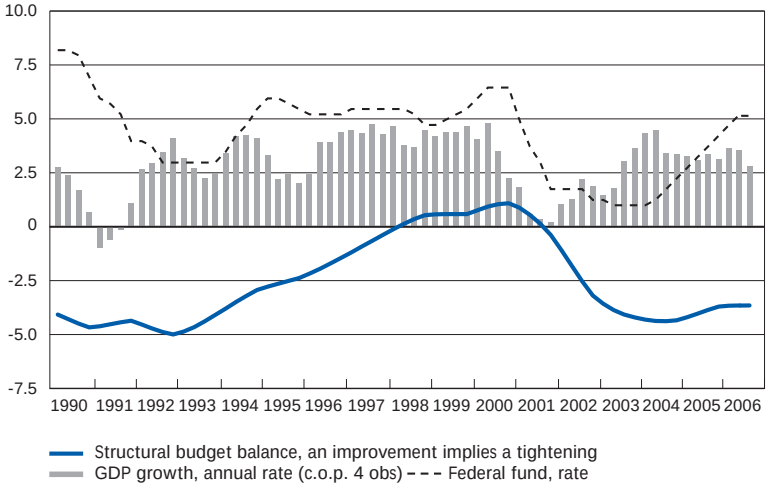
---

32 See Greenspan (2005), p. 3.

33 See "Home Bias and International Risk Sharing: Twin Puzzles Separated At Birth", Sorensen, Wu, Yosha, Zhu, CEPR Discussion Papers No. 5113, Table 3.

34 This is as far back as the OECD calculations go for the structural budget balance, making it hazardous to extend the comparison further into the past.

Figure 4. US federal budget balance (cyclically adjusted), Federal funds rate and GDP growth
Per cent



Note: The figures based on quarterly statistics. The structural budget balance is an interpolation of annual statistics in OECD EO79. FED Funds are averaged quarterly.

est rates have continued to be low in a historic perspective and underlying inflation is still subdued.[35] In 2002 and 2003, the very low rate of inflation even started a discussion about the risks of a deflationary situation like the one in Japan. The recovery of domestic demand has stimulated exports from other countries. The United States has continued to function as the locomotive in the global economy.[36]

Many emerging-market countries admittedly have financial markets that are still regulated and underdeveloped, which clearly affects decisions about saving and investment there. An adjustment to less controlled markets in China, for example, could result in tensions that entail problems for the world economy. But how great is the risk of this? It can even be argued that the effects for the world economy are more likely to be positive. Moreover, economic policy adjustments do not occur rapidly in China. It may therefore be asked how abrupt an adjustment would be.

---

35 The increase in core inflation during 2006 is probably explained to a large extent by increased household expenditure on rent when the high house prices strengthened demand for rented dwellings. House price inflation has slacked substantially and it can be argued that households do not expect the same financial yield from home ownership as before. The official measurements of inflation do not include house prices.

36 If allowance is made, in keeping with the IMF (which focuses on analysing global growth in a welfare as opposed to a market perspective), for differences in purchasing power and price levels, and GDP weights are accordingly applied to countries in PPP terms, in the past ten years the United States has contributed not quite 20 per and China not quite 30 per cent of global GDP growth. It can be argued, however, that in practice the United States' contribution is much larger because, in the light of increased global free trade, the high growth of US demand stimulates exports, investment and GDP growth in other countries. Moreover, if country differences in purchasing power and price levels are disregarded (that is, if GDP statistics are not PPP adjusted), the contribution from the United States to global growth in the past ten years is just over 20 per cent and clearly the largest from any one country; while the figure for China is less than 8 per cent. Whichever way one calculates, in other words, the United States has been very much of a driving force for global GDP growth in the past ten years. That has also been the message in forecasts in this period from the OECD, the IMF and private institutions.

Freer trade alters conditions for the relationship between production and consumption. If the production of goods and services is located where costs are lowest and consumption occurs somewhere else, this has positive welfare effects for all concerned. Trade imbalances may therefore be something that one has to get used to in a world with deregulated capital markets and a larger element of free trade than before. From the viewpoint of free trade the imbalances may even be desirable, even though there are limits to the loans an individual or firm can carry.

Some observers argue, moreover, that the system of national accounts – formulated as it was in the United States and the United Kingdom in the 1930s, when their economies were dominated by manufacturing – is not appropriate for measuring current account balances in a relevant way today.[37] One argument is that it would be more relevant to pay more consideration to the location of ownership. An example is an American automobile manufacturer that chooses to use comparative advantages in the form of low labour costs in Mexico instead of producing at home. When the automobiles are taken home for sale in the US market, this is registered as an import and contributes to the current account deficit. The phenomenon appears to be more common in the United States than in other countries and contributes to US corporate profits. If, instead of the national accounts' flow statistics, more consideration is paid to ownership of production resources and the receipt of profits that contribute to employment and welfare in the home country, the situation looks different.[38] Employment in the United States in the past ten years combined has been stronger than in, for example, the euro area, Japan and the United Kingdom and the development of household wealth has been notably favourable.

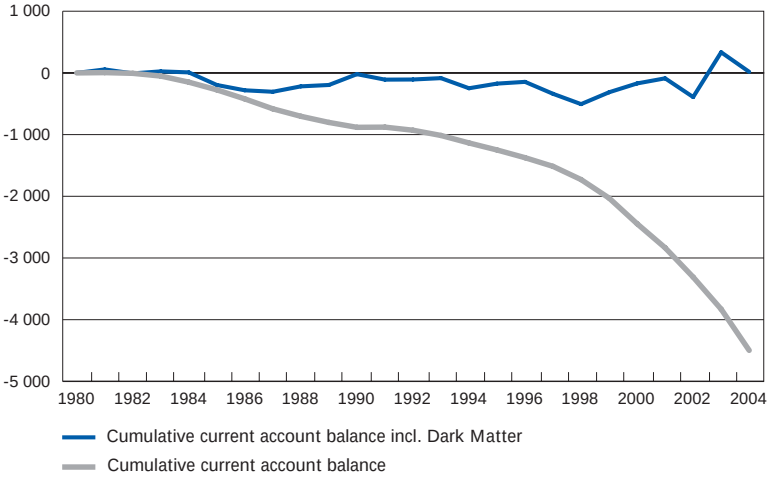
Another sign that the available statistics are not entirely relevant for an analysis of imbalances is the way of measuring household saving, which in recent times results in negative saving in the United States. While this issue is not directly connected with the size of the current account deficit, it does impinge on the distinction between saving and investment and the view that over-consumption today will probably lead to an abrupt upward adjustment of saving. One of the arguments that saving among American households is considerably higher than the official figures indicate is that the picture of disposable income does not make sufficient allowance for new types of income that are becoming increasingly common, for example options, profit sharing, bonus payments and capital gains. Including these items in the statistics would

[37] See Cooper (2005) p. 2.
[38] See McKinsey Quarterly (March 2005).

probably give a different picture of over-consumption in the United States. Another argument is that consumption of durables (e.g. refrigerators) and expenditure on research and development should be treated, not as consumption but as saving in real assets.[39] Immaterial investments, such as training and organisational adjustments, which are treated as current expenditures in the national accounts, are highly important for getting the best out of investment in new technology.[40] Against this background it can be argued that in practice the saving deficit is smaller than the official statistics suggest and the investment ratio is higher. A further reason for believing that household behaviour has been rational is the strong development of wealth. Rapidly rising net wealth means that households' margins are larger than the saving ratio suggests. When these arguments are taken into consideration, it seems less probable that households have behaved irrationally.

It is even argued by Hausmann and Sturzenegger (2005) that, measured with other methods than those used for the official statistics, there is no US current account deficit. Their paper is controversial but interesting. They claim that if, instead of using the normal book values, US companies active abroad are valued to a greater extent in terms of the return on their

Figure 5. United States: net external position in terms of the cumulative current account balance, using official statistics alone or including "Dark Matter"
USD billion



Source: Hausmann & Sturzenegger, (2005), Harvard University.

[39] According to Cooper (2005), private saving is equivalent to around 1/3 of GDP, not to less than 14 per cent with the definition above.
[40] See Bernanke (2005).

investments, a completely different picture emerges (see Figure 5). The concept of returns these authors use is wider than in the traditional balance-of-payments statistics.

The difference is called "Dark Matter".[41] American companies' earnings from assets abroad exceed their borrowing costs even though the liabilities are considerably larger than the assets. These companies have, for a considerable time, had a higher return on investment abroad compared with foreign companies that invest in the United States. A possible explanation for this is that American investors are less averse to risk than foreign investors. Foreign investment in the United States is dominated by bonds, while American companies are more active in direct investment and equity with a higher average return.[42] So the United States' net external investment position looks considerably more satisfactory if allowance is made for changes in the value of the investments.[43]

Conclusions

Although there are many grounds for supposing that the global imbalances are more sustainable in the long run than many believe, an abrupt adjustment that gives rise to negative effects on global growth cannot, of course, be ruled out. The negative effects would, in various scenarios, be felt to some degree in the Swedish economy, with its dependence on foreign trade, and have consequences for Swedish monetary policy.

Forecasts of the global economy by market observers, central banks (including the Riksbank) and international organisations seldom if ever envisage a rapid and uncoordinated correction of the global imbalances. Such a development is included instead, to a greater or lesser extent, in the analysis of risks. One reason for this may be that it is very difficult to foresee just when such an event is likely to occur. It is also hard to assess how probable that course is. Then there is the question of quantifying the effects on particular regions or countries. The impact depends on what it is that initiates the process, the extent to which different factors are involved in the correction and the pace at which it proceeds. In the medium-term perspective it can therefore be natural to simply point to the risk of a sudden correction.

---

41 "Dark Matter" denotes assets that are known to exist even though the income they generate is not visible (or cannot be measured in a relevant way). The expression comes from physics, where it refers to the fact that even though it cannot be seen, certain matter is known to exist because its gravitational effect is observable. According to Haussmann and Sturzenegger (2005), the net external assets of the United States total USD 3.1 trillion; this and more besides is missing in the official statistics.

42 See e.g. Engel (2005), p. 5.

43 If this difference in returns in favour of the United States compared with the rest of the world does not continue, it would probably have to be replaced by some other positive valuation effect in the form of a persistent weakening of the dollar. See Lane and Milesi-Feretti (2005).

The main argument for an abrupt adjustment of the global imbalances is often connected to the risks of increased protectionism in the world economy and a clear fall in US potential growth. There are, indeed, certain signs of a break in the downward trend for trade tariffs. One example is the suspension of negotiations in the WTO's Doha Round. Another is connected with the continued increase in the US current account deficit with China. Some American politicians are highly critical of China's exchange-rate policy, which they consider gives Chinese exports an unfair advantage. There are similar tendencies among some European politicians who argue that China distorts competition by subsidising production and exports. This has, for example, resulted in the EU introducing markedly higher import tariffs on footwear from China and Vietnam. If investors were to alter their perceptions of US potential growth and the advantage in terms of growth and income which they believed would last, the level of indebtedness in the US economy could then be seen as a problem. This might lead to a marked weakening of the dollar[44] and increased uncertainty in global financial markets. Together with increased protectionism, that could lead to negative effects on investment and economic growth. If the euro became rapidly stronger, the Swedish economy could be hit in particular by an economic slowdown in Europe.

There are, however, many arguments against an abrupt adjustment. One is that US growth and incomes are continuing to rise more rapidly than among the main trading partners and that a change in this respect would take time. Moreover, the effects of discontinuing the Doha Round may be mitigated if the number of bilateral free-trade agreements continues to grow. Neither do the US saving imbalances seem to be particularly troublesome when one considers the high return American companies obtain on borrowing and investment at home or abroad and the low return the rest of the world obtains from investment in the liquid US bond market.[45] Another argument against the probability of an abrupt adjustment is that 95 per cent of US external debt is denominated in dollars. So a marked weakening of the dollar would not enlarge external debt.[46] Many observers also consider it fairly unlikely that China would suddenly adopt an entirely different exchange-rate policy and no longer demand dollars, leading to a rapid upward effect on long-term interest rates. A common opinion is that the changes are more likely to occur gradually as China's financial sector develops. Stability seems to be an apt word for

---

44 According to Obstfeld & Rogoff (2005), a correction of the US current account deficit entails a 30 per cent probability of the dollar declining; the study indicates that the possibility of the dollar weakening rapidly by 40–50 percent in trade-weighted terms cannot be ruled out.

45 See the reasoning in Hausmann & Sturzenegger (2005).

46 Besides reducing the valute of external liabilitites, a weaker dollar increases the value of assets, which are mainly denominated in other currencies.

Chinese policy. Moreover, globalisation and less "home bias" favour the United States, which has the most liquid and diversified financial markets. Those wishing to invest abroad can very probably find what they are looking for in the United States. Considering that the share of global saving that is invested in the United States is still relatively small, it can be argued that there continues to be room for additional external portfolio investment there without the share becoming unduly high.

The US current account deficits over the past fifteen years are not without precedent. A substantial deficit also occurred in the 1980s when government net saving was markedly negative and household net saving fell. The deficits subsequently became markedly smaller in the late 1980s when household and business saving rose. Early in 1991 there was even a marginal surplus. One factor behind the diminishing current account deficit was that in the period 1985–88 the dollar underwent an effective depreciation of almost 40 per cent.[47] At that time the OECD issued a warning, albeit cautiously worded, of the risks for the world economy as a result of the global imbalances.[48] It is noteworthy that the correction of the US current account deficit in the 1980s had no sizeable, if any, negative effects either for the United States or for the world economy.[49] Economic development remained favourable in both cases. In the United States the weaker dollar did contribute to sharply increased import prices, rising inflation and hence a substantial tightening of monetary policy but this was largely offset by positive effects on net exports. When global economic activity slackened markedly in 1990–91, the cause was rather the sharp increase in the price of oil at a time when dependence on oil was considerably greater than today. The geopolitical situation in the Persian Gulf generated a lot of uncertainty and US economic activity was also subdued by credit restrictions in the banking sector. Furthermore, a global stock-market fall dampened international economic activity.

A long-lasting current account deficit does not necessarily constitute a problem. A number of other OECD countries have had large current account deficits for considerably longer than the United States without this leading to dramatic corrections.

The imbalances can be seen as a natural consequence of deregulated international financial markets, increased free trade and globalisation, so that today they are more sustainable than they would have been prior to

---

47 See e.g. the reasoning in OECD Economic Outlook 45, June 1989, p 43. The difference today, however, is that economic activity n the euro area is somewhat weaker. In the 1980s there was little stimulus from economic policy. Today the scope for any stimuli that might be called for is extremely limited, partly on account of the EU's fiscal policy rules (the Stability and Growth Pact).

48 See e.g. OECD Economic Outlook 41, June 1987, p. vii.

49 US GDP growth rose from 3.4 per cent in 1987 to 4.1 per cent in 1988; the rate in 1989 was 3.5 per cent. The pattern was similar in the OECD as a whole.

these changes.[50] There is therefore a good prospect that – together with a probable maturing of emerging-market economies, leading in time to decreased saving – policy measures will lead to an orderly correction that has just a marginal effect on the world economy and thereby on the Swedish economy. An orderly adjustment could be facilitated by the measures of economic policy the IMF recommends for individual countries.[51] In most cases these measures are also desirable for other reasons, for instance to raise potential growth and welfare in the country/region in question. There are some indications that this development can be achieved. Oil-producing countries are planning for greatly increased domestic investment, China's exchange-rate policy has been made more flexible in the past year, it seems that structural reforms are already helping to raise potential growth in Japan and US fiscal policy has been tightened.

[50] See e.g. Cooper (2005).
[51] These measures are presented in World Economic Outlook, e.g. April 2006.

References

Bernanke, B., (2005), "Productivity", Remarks by Governor Ben S. Bernanke, Federal Reserve, January 19.

Bernanke, B., (2005), "The Global Savings Glut and the U.S. Current Account Deficit", Remarks by Governor Ben S. Bernanke, Federal Reserve, March 10.

Brynjolfsson, E., (2003), "Computing Productivity: Firm Level Evidence", MIT June.

Cooper, R., (2005), "Living With Global Imbalances: A Contrarian View", Institute for International Economics.

Eichengreen, B., (2005), The Blind Man and the Elephant, University of California.

Engel, C., (2005), "The US Current Account Deficit: A Re-examination of the Role of Private Saving", Reserve Bank of Australia.

Ferguson, R., (2005), "US Current Account Deficit: Causes and Consequences", Remarks by Vice Chairman Roger W. Ferguson at the Federal Reserve Board, April 20.

Greenspan, A., (2005), "Globalisation, Remarks by Chairman Alan Greenspan at the Council on Foreign Relations", New York, March 10.

Hausman, R., Sturzenegger, F., (2005), "US and Global Imbalances: Can Dark Matter Prevent a Big Bang?", Harvard University.

Hooper, P., Johnson, K., Maruez, J., (1998), "Trade Elasticities for G7-countries", FRB International Finance Discussion Paper No. 609.

IMF, World Economic Outlook (April 2006).

The Institute of International Finance, "Summary Appraisal, Gulf Cooperation Council Countries", August 15 2006.

Lane, P., Milesi-Feretti, G.M., (2005), "A Global Perspective on External Positions", IMF Working Paper WP/05/161.

McKinsey Quarterly, (2005), "A silver lining in the trade deficit".

Mann, C., (2002), "Perspectives on the US Current Account Deficit and Sustainability", *Journal of Economic Perspectives* – Vol 16, Nr 3.

Obstfeld, M., Rogoff, K., (2005), "The Unsustainable US Current Account Position Revisted", Maurice Obstfeld and Kenneth Rogoff, *National Bureau of Economic Research Working Paper 10869*.

OECD, Economic Outlook 41 (June 1987).

OECD, Economic Outlook 45 (June 1989).

OECD, Economic Outlook 79 (June 2006).

Regeringens budgetförslag 1976/77, Sammandrag (Summary of budget proposals), Finansdepartementet.

Regeringens budgetförslag 1984/85, Sammandrag (Summary of budget proposals), Finansdepartementet.

Sorensen, B, Wu, Y-T, Yosha, O, Zhu, Y, (2005) "Home Bias and International Risk Sharing: Twin Puzzles Separated At Birth", *CEPR Discussion Papers No. 5113*.

Van Ark, B., McGuckin, R., Spiegelman, M., (2005), "The Retail Revolution – Can Europe Match the US Productivity Performance?", The Conference Board, March.