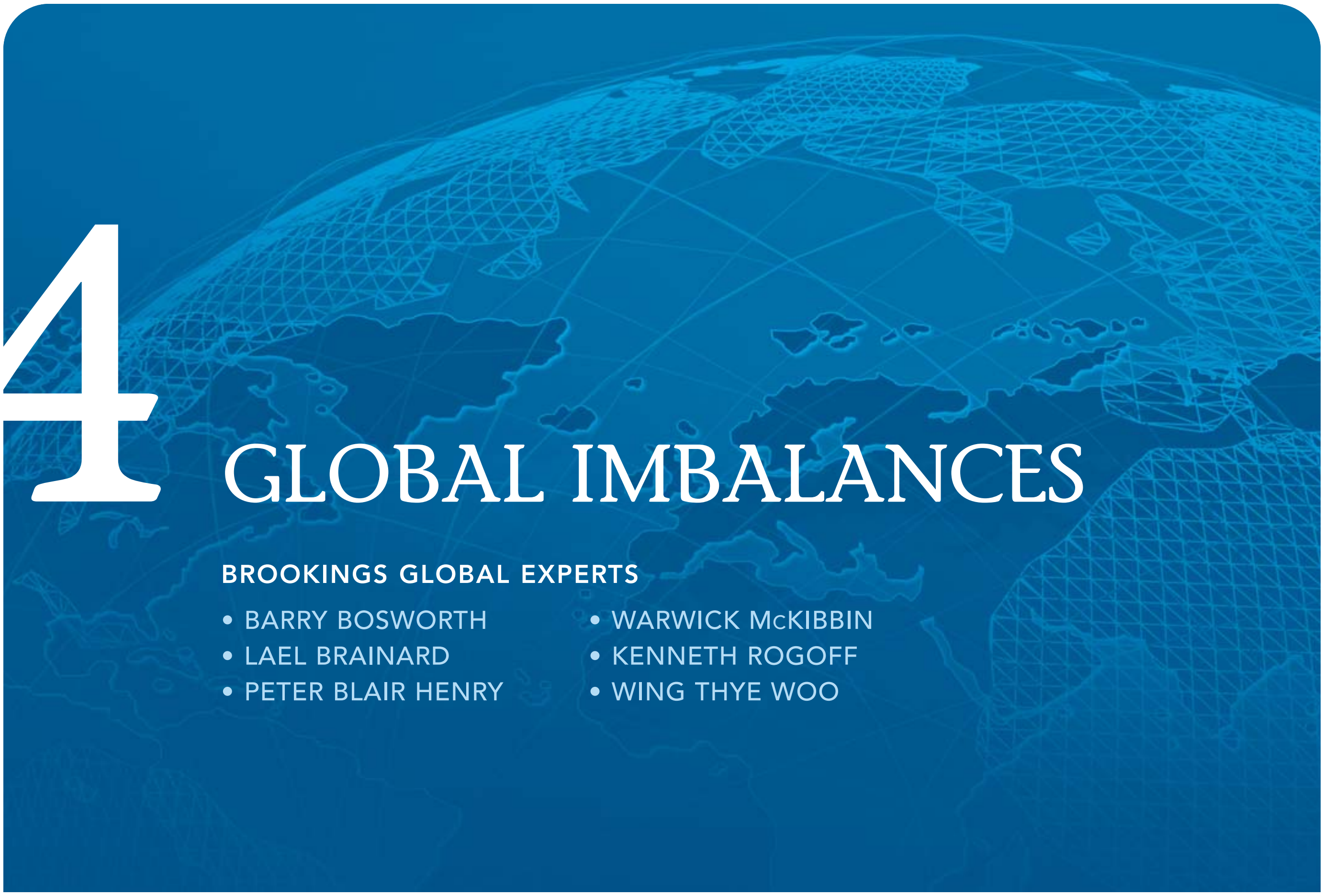

4 GLOBAL IMBALANCES

BROOKINGS GLOBAL EXPERTS

- BARRY BOSWORTH
- LAEL BRAINARD
- PETER BLAIR HENRY
- WARWICK McKIBBIN
- KENNETH ROGOFF
- WING THYE WOO

Today's interconnected world is in uncharted territory. The world's sole hegemonic power, the United States, nurses an addiction to foreign capital, while up-and-coming powers such as China and oil exporters sustain surpluses of increasing magnitudes. Some worry that the world is at a tipping point, where only a dramatic shift in economic policy can alter the looming trajectory. Others see underlying structural factors perpetuating gross imbalances for a sustained period.

Which view is correct matters greatly. Global current account imbalances are true to their name: Though a small number of leading actors such as the United States, Europe, Japan and China have an outsized influence on the size and composition of imbalances, disorderly adjustment would pose risks to all players in the global economy.

THE GLOBAL CONTEXT

Current account imbalances reflect the amount a country borrows from or lends to foreigners each year, equivalent to the gap between what a country invests and what it saves domestically. Although current imbalances are the culmination of investment and saving decisions of a myriad of players around the globe, it is striking that the United States alone absorbed 75 percent of the combined current account surpluses of Germany, Japan, China and other surplus countries in 2004.

It is no coincidence that in the last several years, U.S. consumption and investment have remained strong and borrowing has remained relatively cheap despite a sharp deterioration in the fiscal balance and high energy prices. Indeed, it is precisely the availability of large and growing lending from foreigners that has enabled Americans to have their cake and eat it too. The United States is now running the largest trade and current account deficits in its history—almost twice as great as the highs in the mid-1980s. In 2006, the nation borrowed $890 billion from foreigners—borrowing at a rate of nearly 7 percent of national income. Not surprisingly, foreigners now hold roughly half of all Treasury securities.

It is true America has borrowed heavily in earlier periods—notably in the 1980s. But at that time, the United States was a net creditor internationally. Today, the United States is a large net debtor, and the national savings picture is projected to deteriorate further with the retirement of the baby boom generation. Between 2000 and 2005, foreign debt went from 14 to 25 percent of U.S. GDP—right in line with the indebtedness of Brazil and Argentina on the eve of their financial crises in 2001 (with debt-to-GDP ratios of 18 and 33 percent, respectively).

Although other rich countries have reached high levels of borrowing relative to income, these have been relatively small economies. There appears to be no historical precedent for the largest economy borrowing at these magnitudes on a sustained basis.

THE CHALLENGE

Some financial markets experts are sanguine, believing current large global imbalances reflect underlying structural factors that will persist for some time. China's poor social insurance is reflected in savings rates in excess of 40 percent, which in turn contribute to (although do not fully explain) foreign exchange reserves on the order of $1 trillion. Oil exporters—awash with liquidity—have flooded into the global capital markets. During the same three-year period when U.S. oil imports rose from $104 billion to $252 billion, Saudi Arabia's external surplus rose from 6 percent of GDP to 30 percent.

But others warn of the all-too-familiar risks of growing global imbalances. In a hard landing scenario, there could be a sudden rush to the exits, where investors dump dollar assets, the Federal Reserve would be forced to sharply raise interest rates, housing and equity markets would be adversely affected, and growth could be curtailed.

Even with smooth adjustment, the later corrective action is taken, the more costly it becomes. The cost of servicing foreign obligations will absorb a growing share of U.S. export earnings, so that it will require an even greater turnaround in the trade balance and compression in domestic growth to stabilize the debt-to-GDP ratio.

These debt dynamics make a compelling case for taking corrective action sooner rather than later. Instead, the approach so far has been to leave it to the market to work though the global imbalances. But this approach begs the difficult question of global burden-sharing in the adjustment process. So far, those countries with market rates—Europe, Canada, Australia and Latin America—have taken a disproportionate share of the burden, while China and Japan have essentially taken a free ride. Moreover, it misses the opportunity to diminish the cost by encouraging markets and currencies to adjust sooner rather than later.

RECOMMENDATIONS FOR ACTION

Given the potential collateral damage if global imbalances continue to spiral out of control, it is essential to consider a range of policies that could gradually reduce global imbalances now rather than later. Most economists agree that a mid range strengthening of the Chinese yuan would unlock a broader move toward currency adjustment by China's neighbors, take some of the pricing pressure off U.S. manufacturers and improve the macroeconomic climate in China. However, although it is a critical component of a broader package, a mid range revaluation of the yuan would not by itself ameliorate the overall U.S. current account balance. Though China may run surpluses similar in size relative to GDP as Germany and Japan, China commands a much smaller share of global surpluses in absolute terms.

The best path to facilitate an orderly decline in global imbalances while supporting continued growth is through a combination of mutually reinforcing actions—continued improvement in the U.S. fiscal balance along with encouragement for increased private saving, a significant strengthening of the Chinese yuan accompanied by further appreciation of other Asian currencies, and measures to strengthen growth in Europe and Japan. Both the IMF and an expanded Group of Seven (G7) could be used to advance these goals far more effectively than they have to date.

WANT TO READ MORE?

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