

COMMENTS ON “UNDERSTANDING GLOBAL IMBALANCES”

Guy Debelle
Head of International Department
Reserve Bank of Australia¹

Australia has had a long history of current account deficits, or capital account surpluses if I were to use the terminology of this year’s Economic Report of the President. The current account deficit in Australia is currently around 6 per cent of GDP and has averaged 4½ per cent over the past 20 years (Graph 1). Net foreign liabilities are around 60 per cent of GDP, with much of that being in the form of debt.

In Australia, we debated the issue of sustainability of current account deficits extensively during the 1980s. A lot of the arguments that are being aired at the moment bear a striking similarity to the debate that occurred in Australia throughout the 1980s. Now, two decades on, by and large, the majority view of economists in Australia is very similar to that put forward in this excellent paper by Richard Cooper. Although it must be said that while most economists are relaxed about the current account, it still can engender a significant amount of fear amongst politicians and the public, almost the reverse of the situation in the US. The view reached in Australia is akin to the “consenting adults” view of the Lawson doctrine, although it should be noted that this argument was made by John Pitchford and Max Corden quite some time before Lawson.²

It is true that Australia is a much smaller issue for global capital markets than the US, but I don’t think absolute size matters as much as the share in global portfolios, in which case the lessons from the Australian experience broadly scale up.

Given that I broadly share the views expressed by Professor Cooper whereas a sizeable share of the economics profession, including a number of those sitting in this room, do not, in my comments I will generally try to amplify a number of the arguments Professor Cooper makes, rather than dwell on the few small issues where we may disagree.

¹ The views expressed are those of the author and not necessarily those of the Reserve Bank of Australia.

² Pitchford (1989), Corden (1991).

Cooper's analysis from a savings-investment and a capital account perspective does provide some useful insights which are ignored if one only focuses on the current account itself. It gives quite a different perspective on the issue of sustainability and calls into question whether what we are observing are indeed "imbalances". To his analysis, I would like to add a balance sheet perspective. Imbalances in the end are an issue of stocks as much as flows, but the current debate about imbalances only focusses on the flows. Stocks can change not only because of flows but also from price changes, that is valuation effects. A balance sheet analysis which focuses on the stocks leads one to examine questions such as the treatment of capital gains, and valuation effects more generally, in the traditional measures. Valuation effects are not in the balance of payments, nor in the national income accounts.

How are people saving?

Cooper provides interesting details on the movements in saving and investment in the United States which have been the counterpart of the widening in the current account deficit. He makes a number of arguments as to why the traditional measure of saving may give an inaccurate picture of the "true" position of US households. In terms of the "imbalances" argument, however, one has to argue that these issues of mismeasurement are more relevant for US households than they are for households in other countries, and I think it would be interesting for the paper to spend more time examining this issue. US households may spend more on education than households in other countries, but to have an impact on current account positions, it would have to be the case that the share of education spending is rising faster in the US than in other countries, or that the rate of return on education is rising faster in the US than elsewhere.

The stronger argument that Cooper makes, which I would like to develop further, is that the nature by which US households are saving differs substantially from that in other countries, although it is similar to the UK and Australia. US households have a greater share of their savings in the form of equity than do households in other countries. This has important implications about how one thinks about imbalances. The capital gains on these equity holdings are not recorded in the national accounts. They are however recorded when one looks at national balance sheets, but more on this below. One can debate the issue as to whether the capital gains that US households have experienced from the rise in

house prices also constitutes a source of saving. To my mind, they do not, so in what follows, my arguments will focus only on saving in the form of equity holdings. If one treated capital gains from housing in the same way, the argument is even stronger.

Take the case where households in country A save only in the form of bank deposits or the purchase of government securities but households in country B invest all their savings in equity. Assume that total returns are equalised across these two investments. The national accounts records the interest income earned by the households in country A on their savings as household income but it only records the dividend payments on the equity holdings in country B as income. The capital gains on the equity investments are not recorded in either the national accounts or balance of payments. Yet the capital gain is a significant part of the return on the equity investment for the households in country B. From the national accounts perspective, the households in country B will be doing less saving than those in country A.

Now take the case where the households in country A lend their savings to the households in country B who in turn invest the borrowed funds by purchasing equity in country A. Again assume the interest on the loan is equal to the return on the equity investment which comprises dividend payments and a capital gain. The national accounts will again show less saving in country B than in country A. And country A will be recording a current account surplus while country B will be recording a current account deficit. This is because the net income flows, as recorded in the balance of payment statistics, will be from country B to country A, as the interest payments will exceed the dividend payments (assuming a positive capital gain). Wealth holdings will be the same in both countries and households expected permanent income will also be the same. Country B's current account deficit will be persistent, yet I would not say that there is an imbalance here. The argument is even stronger if one allows for an equity premium.

Obviously, the rest of the world, and particularly east Asia are broadly akin to country A, and the US, UK and Australia are broadly akin to country B.

So the bottom line is that these measurement issues need to be taken into account when examining global imbalances. The problem doesn't necessarily go away but it does result in a different

perspective on the scale of the problem. Valuation changes do not make it into the current account, but they do affect the measurement of the stock of liabilities.³

A balance sheet approach to global imbalances

Taking the argument that Cooper makes that the national accounting system may not be providing the most appropriate metric for assessing global imbalances one step further, I would like to argue that the standard analysis of the current/capital account flows should be combined with a balance sheet or stock analysis.

Most analyses of global imbalances start from either the size of the current account or the size of foreign liabilities relative to GDP. However, measuring foreign liabilities relative to GDP is not necessarily the most appropriate benchmark to use, as it is deflating a stock (foreign liabilities) by a flow (GDP). When assessing the borrowing of a corporation, a balance sheet perspective is generally used in the form of gearing ratios which measure debt against assets or equity. Measures of debt service are used to assess the ability to service that borrowing.⁴

Using a balance sheet approach to assess the external position of the United States suggests that the stock of foreign liabilities should be deflated by the assets held by US residents or, in other words, a measure of wealth. One can regard the wealth as the collateral against which the stock of liabilities is held. Again, one can debate whether housing wealth should be included in this calculation, so for the purpose at hand, I have shown the analysis with and without housing.⁵

One can see from Graph 2 that this balance sheet analysis presents quite a different picture. Foreign liabilities have risen at a much smaller pace relative to wealth than they have relative to nominal GDP. Obviously this reflects the fact that the value of US households' holdings of equity, and financial wealth more generally, have been rising faster than GDP. This is valuation effects at work. Hence

³ Pierre-Olivier Gourinchas and Helene Rey (2005), Gian-Maria Milesi Feretti and Philip Lane (2004) have written extensively on this as has Cedric Tille (forthcoming).

⁴ A similar argument applies to the measurement of household borrowing, where household debt should be scaled by the value of household assets, rather than household income, which is generally used.

⁵ The wealth numbers for the US are from the Flow of Funds statistics.

expressing US foreign liabilities as a share of wealth gives quite a different picture of “sustainability” or vulnerability”. The same is true of Australia.

As US households are doing more of their saving through equity than other households, then this sort of analysis presents a much more benign picture. In net terms, foreign liabilities have been stable as a share of wealth over the past few years. In Australia, they have actually declined.

In addition, in the event of any depreciation of the US dollar, net foreign liabilities will decrease significantly because of valuation effects, further bolstering the balance sheet of US households.

Why are the flows going to the US?

An important question that Cooper asks is why is it that the capital flows are all going to the US. I think the answer he gives is the correct one, namely the US possesses a developed secure financial system which offers a respectable and reliable rate of return. I would particularly emphasise the words “secure and reliable”. A recent paper by Ricardo Caballero, Emmanuel Farhi and Pierre-Olivier Gourinches (2006) formalises this argument, and concludes that the current alignment of capital flows is stable and liable to persist for quite some time to come.

One conclusion that one can draw from this analysis is that one of the greatest benefits from economic reform in Japan and Europe in terms of global imbalances is to make them more attractive destinations for the savers of the world. Similarly, developing “secure” financial systems in Asia would yield a similar outcome. But that is a slow process, not one that will take place overnight. Hence one would expect the portfolio adjustment as these reforms took place, and investors perceptions changed, to be quite gradual too.

Is the share of US assets in global portfolios likely to reach saturation soon? Cooper notes that the US is maybe slightly underweight in the global portfolio. There has been a notable decline in home bias over the past decade or so, as the process of financial globalisation has proceeded, but primarily the destination of those funds has been the US. So ignoring home bias, the US portfolio allocation is about right, whereas most other countries are underweight.

A crude characterisation might be as follows: there has been a general decline in home bias over the past two decades, but there has not been a general portfolio diversification. Instead investors have tended to put their funds in markets which are seen as secure and dynamic. Thus far, the investors of east Asia, and more recently, the oil-producing countries, have made the assessment that the US provides them with the investment characteristics they are after.

Given that their investment strategy has been to invest predominantly in US assets, and importantly, US dollar denominated assets, an interesting question arises. If I have a large portfolio in the US, measured in US dollars, and the US dollar depreciates, do I increase my investment in the US to bring my US allocation back up to my benchmark, or do I rush for the exits generating further capital losses on my US investment which is a large share of my overall wealth portfolio? This is clearly an issue for the central banks of the world with their large US dollar portfolios. Again, valuation effects matter here, which an analysis only of the flows will overlook.

A final variant on this question is: do we expect to see a rapid portfolio readjustment, or in other words, is there likely to be a sudden stop in the US? Gabriele Galati and I have looked at the issue of current account reversals from the capital account perspective.⁶ We find that there is almost no evidence of a “sudden” stop in developed countries. By and large, capital flows adjust quite seamlessly, particularly in a floating exchange rate regime.

If it is a problem, what do you do about it?

If after one has examined the issue from a balance sheet perspective, one still concludes that the current account per se is a problem, or is symptomatic of some other problem, what should be done about it?

If household saving is too low in the US, what are the distortions that are causing this inadequate saving? What policies can be put in place to encourage higher saving? I don't think we have good answers to those questions.

⁶ See Debelle and Galati (2005).

One can argue that the US administration needs to address the fiscal situation, but that is an issue of sustainability of the public debt regardless of whether it is held by foreigners or domestic residents. Moreover the twin deficits are probably distant cousins rather than identical twins.⁷ The experience of Australia certainly highlights this point: our budget position has swung from deficit to surplus a number of times with little obvious effect on the current account.⁸ Even if one allows for a near twin-like relationship, then the US current account would only decline to a level that many considered excessive only a few years ago.

If one is concerned about the capital flowing into the US, then would the policy recommendation be that US reimpose capital controls? The capital that is flowing in is coming in willingly: the US is not forcing the rest of the world to lend to it. This is evident in the fact that US interest rates have been generally low. The rest of the world is providing the funding to the US (and Australia) at low cost, whose residents can then turn around and invest profitably. Why would you say no to such funding?

Should policy-makers in the US engineer a recession to make US assets less attractive? Or should they adopt policies that make the US a less attractive place to invest? Clearly that is nonsensical, although it appears that some lawmakers in the US are considering this solution. Self-imposed restrictions such as the Dubai Ports decision are perhaps the greatest threat here. Financial protectionism may be more of a threat to global stability than protectionism in goods and services.

Conclusion

In the very long run, I expect that the configuration of capital flows would not look like they currently do. I would expect capital to be flowing from the developed world to the less developed world. I would not expect to see such an extreme allocation of net capital flows where the flows of capital are disproportionately to a small number of countries. So in that sense the current configuration of capital flows is probably unsustainable but that does not mean we are on the verge of catastrophe.

⁷ Enders and Lee (1990)

⁸ See Gruen and Sayegh (2006)

Changes such as developing sound and trusted financial institutions, enhancing the attractiveness of Europe and Japan as destinations for investment flows are very slow moving, and are not likely to see a rapid reallocation of portfolio flows. Moreover, the large long positions that many global investors hold in US dollars means that there is probably a built-in stabiliser. I do not expect to see a sudden stop in the US or Australia.

The experience of Australia shows that current account deficits or capital account surpluses can persist for quite some time. The paper that Professor Cooper has written provides a number of sound reasons why this might be also the case for the US. The issues he raises about the means by which households in the US save and the treatment of capital gains on those investments are important and often neglected. More generally, a more considered analysis of the balance sheet of the US would lead to a more balanced assessment of the global “imbalances” and the sustainability of the current configuration of global capital flows.

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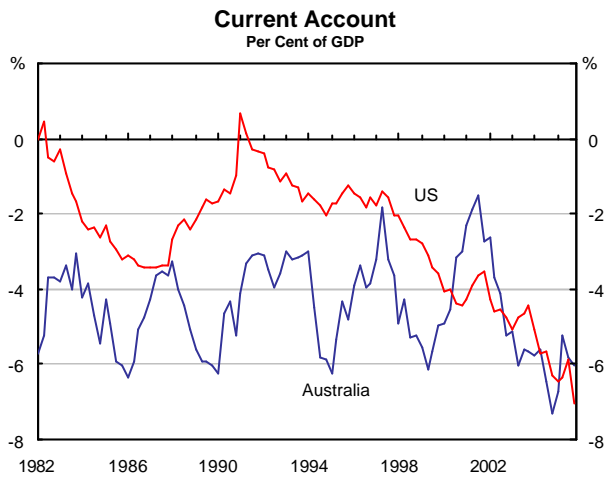
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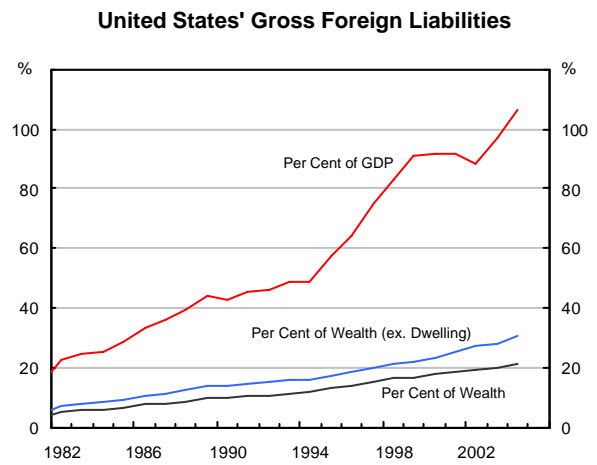
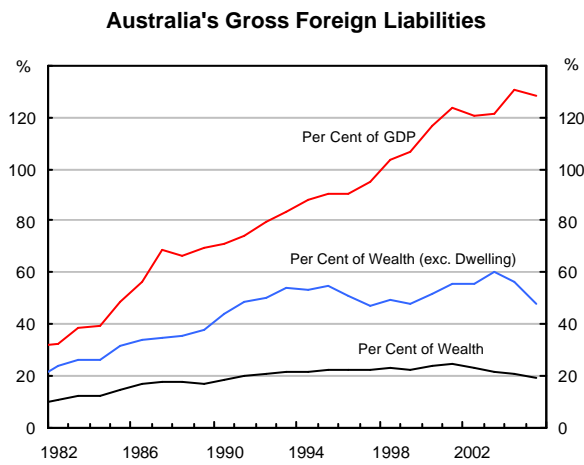
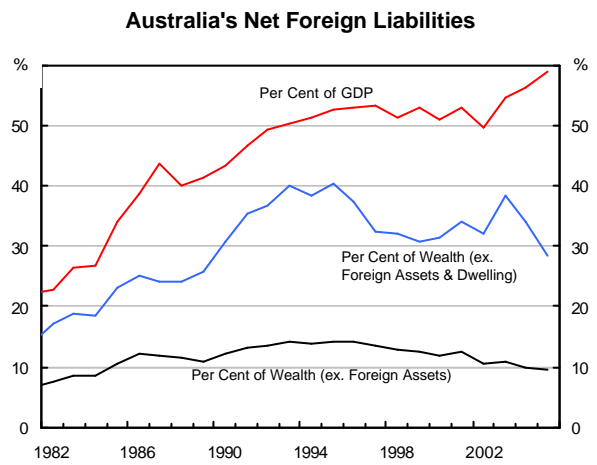
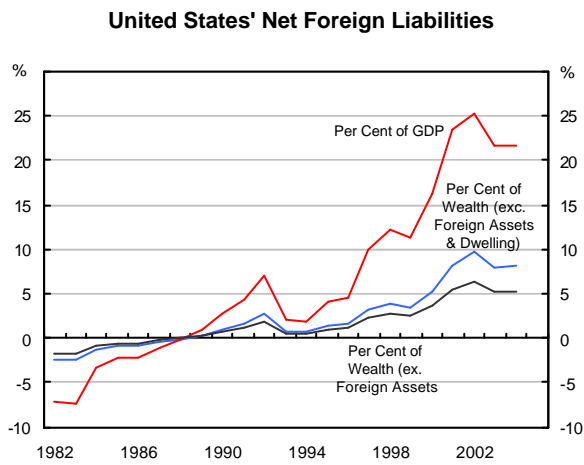
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Graph 1:



Sources: Australian Bureau of Statistics, BEA

Graph 2



Sources: Australian Bureau of Statistics, BEA, Federal Reserve Board, Reserve Bank of Australia