

## Global imbalances

## Sustaining the unsustainable

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**Global investors are worried about many things. Why is America's current-account deficit not one of them?**

SOUR subprime mortgages, sluggish retail sales, the spectre of a broader retreat in credit and consumer spending. These are the American shadows that spooked investors across the globe this week, once again sending share prices tumbling from Manhattan to Mumbai.

For years, the longest shadow of all was cast by America's imposing current-account deficit. But in these fretful times, no one seems to be fretting much about the country's heavy reliance on foreign funding. New figures on released March 14th showed that Americans spent some \$857 billion more than they produced in 2006, the equivalent of 6.5% of GDP, and a new record. China's trade surplus in February was the second-highest on record. It has reached almost \$40 billion in the first two months of this year, three times as high as it was a year ago.

China's government, one of America's best creditors, has announced it is seeking a better return on a chunk of its foreign-exchange reserves. It will create a new investment agency, which looks sure to diversify some of the central bank's assets out of the American Treasury bonds that now dominate its portfolio (see [article](#)).

None of this had much effect on the dollar. Measured on a trade-weighted basis, it has fallen by a

mere 0.04% since the recent financial turbulence began on February 27th. And as investors yawn at America's deficit, so too do policymakers. A year ago, finance ministers and central bankers from the G7 group of big, rich countries promised to take "vigorous action" to resolve the imbalances between the world's savers (particularly China, Japan and the oil exporters) and borrowers (especially America). The IMF was hoping to reinvent itself as the overseer of this grand macroeconomic bargain. A year later the venture has fizzled. The IMF-sponsored discussions between China, Japan, Saudi Arabia, America and the European Union have yielded little. They may be quietly forgotten.

What explains this nonchalance? By some measures, the world is already rebalancing. The dollar after all has fallen by 16% from its 2002 peak in real terms. Compared with the previous quarter, America's current-account deficit shrank in the last three months of 2006 and was below \$200 billion for the first time in more than a year (see chart). That decline owes a lot to lower oil prices. But even excluding oil, America's trade balance seems to be stabilising as exports boom and imports slow. Even so, it is hard to escape the conclusion that both investors and officials have become less worried about global imbalances. This is mirrored in academia, where opinion on global imbalances also seems to be changing. A few years ago most economists argued that the spectacle of poor countries bankrolling America's deficits was the perverse and unsustainable consequence of American profligacy. Economic theory suggested that capital should flow from rich countries to poor ones, and that America could not increase its foreign borrowing for ever. Empirical studies showed that deficits of more than 5% of GDP caused trouble.

Since then, economists have vied with each other to overturn this orthodoxy. Indeed, rejecting the conventional wisdom is now itself entirely conventional, as Jeffrey Frankel, an economist at Harvard University, has pointed out.

Three years ago, Michael Dooley, David Folkerts-Landau and Peter Garber, all economists at Deutsche Bank, argued that the world economy was enjoying a reprise of the Bretton Woods era. America's large external deficit could be sustained for years as Asian central banks kept their currencies cheap in order to foster export-led growth. In 2005 Ben Bernanke, now chairman of the Federal Reserve, pointed out that global interest rates were oddly low, suggesting a glut of saving abroad, not a shortfall of saving at home, was responsible for the flow of capital to America.



More recent papers have picked up similar threads, arguing that imbalances might prove to be both more persistent and less perverse than once thought. A study last summer by three economists at the IMF, for instance, showed that poor countries which export capital have grown faster than those which rely on importing it from abroad.

One reason may be the feebleness of their financial markets. That is a thesis explored by Ricardo Caballero and Emmanuel Farhi of the Massachusetts Institute of Technology, as well as Pierre-Olivier Gourinchas of the University of California, Berkeley. They point out that emerging economies have been frantically accumulating real assets, such as assembly lines and office towers, but their generation of financial assets has not kept pace. Thanks to weak property rights, fear of expropriation and poor bankruptcy procedures, many newly rich countries are unable to create enough trustworthy claims on their future incomes. Lacking vehicles for saving at home, the thrifty buy assets abroad instead. In China, Mr Caballero argues, this is done indirectly through the state, which buys foreign securities, such as Treasuries, then issues bonds of its own, which are held by Chinese banks, companies and households.

Because emerging economies' supply of financial instruments is so unreliable, people may hoard more of them as a precautionary measure. Firms and households fear they will not be able to borrow to tide themselves over bad times, therefore they choose to save for a rainy day instead. Because they cannot transfer purchasing power from the future to the present, they must store it from the past.

If global imbalances are the result of such frictions, they are unlikely to unwind quickly. Financial systems, after all, do not mature overnight. If Mr Caballero is right, America is also less vulnerable to a sudden run on its securities. Where, he asks, would the excess demand for global assets go?

So far, the behaviour of financial markets seems to vindicate his point. But, as Mr Caballero acknowledges, his thesis is largely conjectural, supported only by "spotty" academic work. And it would be a mistake to place too much faith in these new studies. If the dollar tumbles, there will be plenty of academics ready to take the old theories off the shelf and eager to say: "We told you so."