

Global Imbalances—Just How Dangerous?

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- *Growing current account surpluses in Asia and among oil-exporting countries, alongside a growing current account deficit in the United States, have raised concerns that such imbalances pose a threat to the world economy, especially if they are reversed in a disorderly manner.*
- *A related worry is that surplus savings in emerging-market economies are financing the U.S. deficit instead of supporting investment and growth in these emerging-market economies.*
- *Experts are divided on the gravity of this situation. Some believe that normal market forces will resolve these imbalances over time; others argue that policy-makers should facilitate the adjustment with policies that curb domestic demand in deficit countries and stimulate it in surplus countries.*
- *The most likely outcome is an orderly transition back to a more “normal” situation, especially if market forces are allowed to work, but the longer these imbalances persist, the greater the risk of a sharper reversal that could destabilize the world economy and undermine growth. There is also a danger that some countries might resort to policies of trade protectionism to reduce the imbalances.*

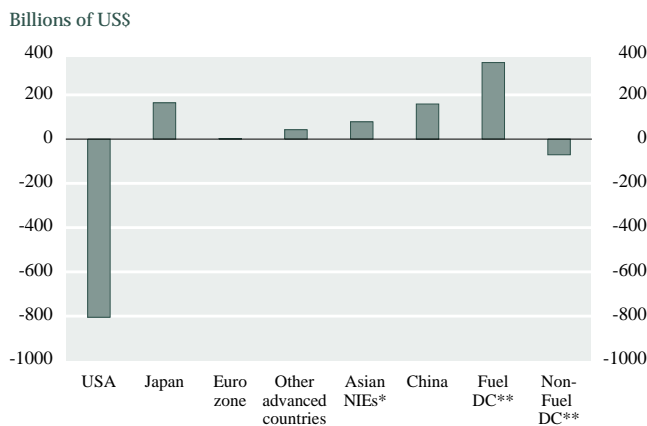
In a world economy that increasingly interweaves the fortunes of all countries, concerns have arisen over the phenomenon known as global imbalances. That major imbalances exist is almost unquestioned, although there are a few skeptics; however, the nature, extent, and urgency of the risk that imbalances pose to global economic growth and financial stability is less clear. These features automatically make global imbalances an ideal subject for the hundreds of studies, reports, articles, speeches, and conferences, both public and private, that have been devoted to the myriad issues surrounding them. For the most part, debate has been limited to the international organizations, central banks, academics, and other analysts who follow these questions most closely. But the issues are important enough, and the potential consequences serious enough, that a broader public understanding is important.

When we talk about global imbalances, we are referring to the current account deficit of the United States and the offsetting current account surpluses of many emerging-market countries in Asia and of oil-exporting countries. Both are large and growing. In 2005, the United States ran an external deficit of US\$805 billion, double its 2001 level and equal to about 6 per cent of its gross domestic product (GDP), while China had a surplus of US\$159 billion, or 7.1 per cent of its GDP. Substantial surpluses can also be found in several East Asian and oil-producing countries (Chart 1). Successive annual surpluses have allowed Asian countries to accumulate over US\$2 trillion in foreign exchange reserves, with China alone holding US\$875 billion at the end of February, when it overtook Japan to become the world’s largest holder of reserves.

This is not normal. Until this decade, the world tended to stay in rough balance. Current account balances in absolute terms—ignoring the plus and minus signs and focusing solely on the numbers—ranged from 2 per cent of world GDP to just over 3 per cent.

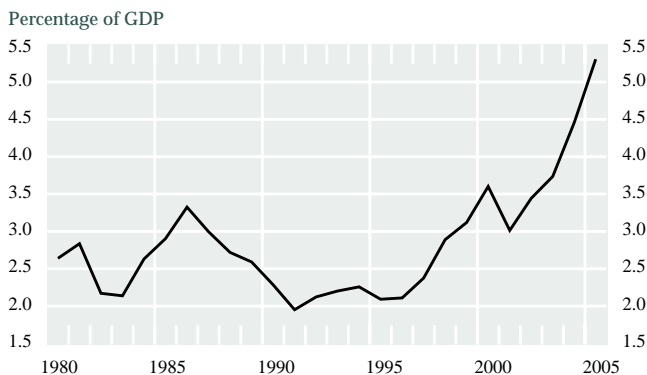
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Chart 1
Current Account Balances by Region, 2005



* Asian NIEs = Asian newly industrialized economies
 ** Fuel DC = Fuel-exporting developing countries;
 Non-Fuel DC = Non-Fuel-exporting developing countries
 Source: IMF, World Economic Outlook, April 2006

Chart 2
Aggregate of Current Account Balance in Absolute Terms



Source: IMF, World Economic Outlook, April 2006, BoC calculations

Since 2002, however, absolute balances have climbed from 3.6 per cent to over 5 per cent of global output (Chart 2). The size of today's imbalances and their recent growth have set off a vigorous debate. The conclusion of almost every analysis—there are exceptions, as we shall see—is that such imbalances are unsustainable, a word whose meaning is best captured in the memorable aphorism of the late U.S. economist Herb Stein: “If something cannot go on forever, it will stop” (Greenspan 2000).

What fuels the debate over global imbalances is disagreement on almost all the important questions. What caused the sudden emergence of wide imbalances? When will they stop growing—sooner or later? What will stop them—underlying economic forces, government policy action, nervous financial markets, or a combination of all three? How will they stop—gradually or abruptly? What harm can be attributed to imbalances and what damage might a reversal cause? Who will benefit and who will lose?

The official international community has entered the debate repeatedly through a wide range of organizations, such as the G-7 major industrialized nations, the broader G-20, and the International Monetary and Financial Committee of the International Monetary Fund (IMF). All have raised concerns that the inevitable shrinking of large current account surpluses and deficits, when it comes, might seriously undermine global economic growth. A disruptive adjustment would involve the sudden realignments of major currencies (marked by a steep depreciation of the U.S. dollar

against many other currencies) and perhaps even a revival of trade protectionism that would choke off ordinary trade flows. It goes almost without saying that policy-makers in general would like to avoid such an outcome. In the main, however, they have been reluctant to adopt policies to address the issue, preferring in many cases to point the finger of blame elsewhere.

How this ends matters to all countries. The latest wave of globalization has integrated emerging-market economies (EMEs)—notably China and India—into the global economy, spreading the gains from trade more widely than ever before. Economic globalization has been beneficial, notably in reducing poverty rates in Asia. It has fostered increased competition and has allowed more countries to benefit from their comparative advantages in world markets. At the same time, financial globalization has stimulated foreign investment and a broader and more efficient allocation of savings. More countries now have more to lose from a major disruption. Canada has a special stake in the outcome, since international trade has always been a key source of this country's development and prosperity. As a trading nation with a more open economy than most, Canada feels the impact of anything that affects the health of the global economy.

Anyone who has tried to follow the global imbalances discussion knows that there are wide, and often deep, divides among researchers and opinion leaders on the key questions, so it is often difficult to keep these disparate views in perspective. Our goal in this article is

to bridge that gap and offer an accessible guide to the major issues and controversies.

Three Views of Global Imbalances

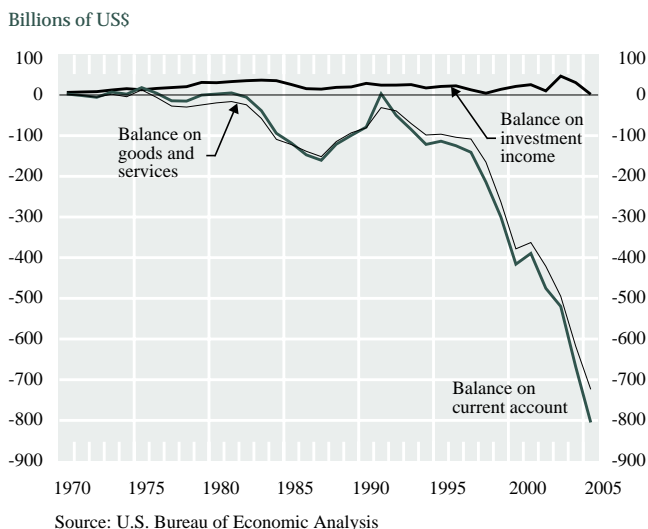
There are three main camps in this debate. The optimistic view is that the global imbalances reflect decisions—based on economic factors alone—by firms and households that are increasingly integrated in a global economy. From this perspective, the situation is not very alarming because market forces will resolve the imbalances over time in an orderly manner. What is really needed is better research to understand how technological, political, and market forces have interacted to bring this situation about. The pessimistic view is that policy-makers will fail to stimulate domestic demand in countries with large current account surpluses and to curb it in countries with large deficits, thus increasing the probability, as Nouriel Roubini has put it, “that the global rebalancing will be disorderly and occur through a hard landing of the U.S. and the global economy” (2005). A third group is cautiously optimistic that the imbalances will be resolved in an orderly fashion but worried that governments will not encourage this outcome by removing distortions that are thwarting market forces.

In this debate, there are optimists, pessimists, and cautious optimists who hope for an orderly resolution of imbalances but worry that governments will get in the way of the outcome.

All three positions have champions among the academic economists who take an interest in these issues. Most international organizations, such as the IMF, the Bank for International Settlements (BIS), and the Organisation for Economic Co-operation and Development (OECD), fall into the third group, as do many policy-makers in countries like Canada. The key players, notably the United States and China, appear to be less concerned, or alternatively, more likely to seek policy initiatives from other countries as being most useful to resolve these imbalances. In the place of concrete policy development, “one finds in the United States some-

Chart 3

Components of the U.S. Current Account



thing between complacency and denial, and in the rest of the world finger pointing and hand wringing” (Truman 2005, 32). This is true to a point, but finger pointing, complacency, and denial know no borders.

What Do We Mean by Global Imbalances?

To understand better what is going on, we need both a global and a local perspective, as well as an interpretive framework.

Many people see the current account strictly through the lens of the cross-border flows of money tracked by statistical agencies and reported quarterly in the media: a deficit country consumes more than it produces and thus imports more than it exports, using the broadest possible definitions of those terms; conversely, a surplus country exports more than it imports. This approach is valid, but incomplete. Saving and investment, which does not show up directly in the popularly reported data, plays a crucial role.

It works this way. The current account balance summarizes a country's transactions with the rest of the world over a period of time. It has two main components. First, the trade balance represents the difference between a country's receipts for the goods and services it exports and its payments for the goods and services it imports. Second, the balance of net income receipts tracks two smaller categories of cross-border receipts and payments: one is the interest and dividends paid on bonds and stocks held by people in other countries;

the other involves financial transactions like transfers by individuals, most commonly when immigrants send money to family members back in their home countries. The current account, then, is a measure of flows—it follows regular movements of money across borders. In the case of the United States (Chart 3), the current account deficit is driven almost entirely by a large deficit in the trade of goods and services.

When a country runs a current account deficit, its receipts from international transactions of all kinds are too small to cover its payments. In effect, the country is spending more than it is earning and borrowing from abroad to pay the difference. This is usually seen from a consumption perspective; the country is consuming more than it is producing, and satisfies its excess consumption with imported products, which it pays for with money borrowed from foreigners. True enough, but there is another way of saying the same thing: the country is not saving enough of its current production to meet its investment needs.¹ This cannot happen for the world economy as a whole. Savings are the source of investment capital, and because the planet is a closed economy, total savings must always equal total investment.²

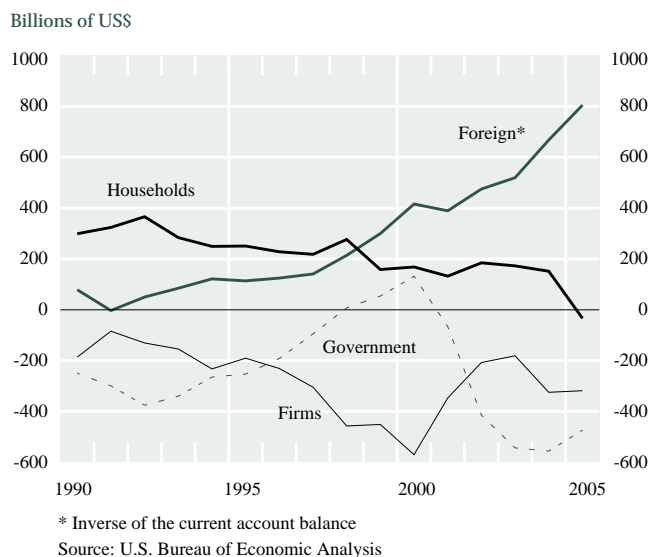
Since individual countries trade with each other, however, they can borrow and lend their savings. Countries that save more than they invest at home (China, for example) wind up with surplus savings, so they become capital exporters and have current account surpluses. Countries that invest more than they save domestically (the United States, for example) have insufficient savings, so they become capital importers and have current account deficits. The former are net national savers; the latter, in the jargon of economics, are net national dissavers, a word that does not trip lightly off the tongue.

The concept of net national savings, the difference between saving and investment, is sometimes difficult to grasp because it is the sum of net savings by three groups—households, firms, and governments. Typically in industrialized countries, households are net savers in that they save more than they invest, while companies are net dissavers, since they borrow to invest in new

1. A little math can show this. Let Y be national income (or gross domestic product); C , total consumption; S , national savings (= income minus savings); and FS , foreign savings. Then, for a closed economy: $Y - C = S$ and $Y - C = I$, or $I = S$; for an open economy: $I = S + FS$.

2. While true in theory, it is a bit more difficult to show this in official data. Statistical agencies cannot track every transaction, so there are omissions and errors.

Chart 4
Net Savings



buildings and machinery to increase their productive capacity or to increase efficiency. Governments that run fiscal deficits are, of course, net borrowers (or dissavers). If those three groups collectively save less than they invest, their country must turn to non-residents to make up the difference.

The Emergence of Major Imbalances

In the early 1990s, U.S. borrowing from the rest of the world was relatively small because U.S. households saved enough to finance most of the needs of firms and governments (Chart 4). As the borrowing needs of U.S. companies increased sharply towards the end of the decade, and household savings fell, the need for foreign savings rose, though the increase was modest because governments were running surpluses—saving instead of dissaving. By 2005, however, U.S. households, firms, and governments alike had all become net borrowers (Chart 4). Together, they were saving an amount equal to 14 per cent of GDP, but investing 20 per cent of GDP. They made up that 6 percentage point gap by importing capital from the rest of the world.

Those imported savings, recorded in the United States' capital account, are the flip side of the current account deficit, which could, according to some predictions, grow from its present level of 6 per cent of GDP to as much as 10 per cent in a few years. The deficit is not only large in terms of historical norms for the United

States and large industrialized countries, but also in terms of the capital flows it generates. In 2004, the United States alone absorbed about 70 per cent of the world's net international capital flows; in other words, of every dollar that savers worldwide were willing to lend to people in other countries, 70 cents ended up in the United States. Just to finance its savings shortfall, the United States must now import more than US\$65 billion a month—the savings of people outside the United States—to pay its bills to the rest of the world. The monthly data on those money flows are now watched closely by financial markets.

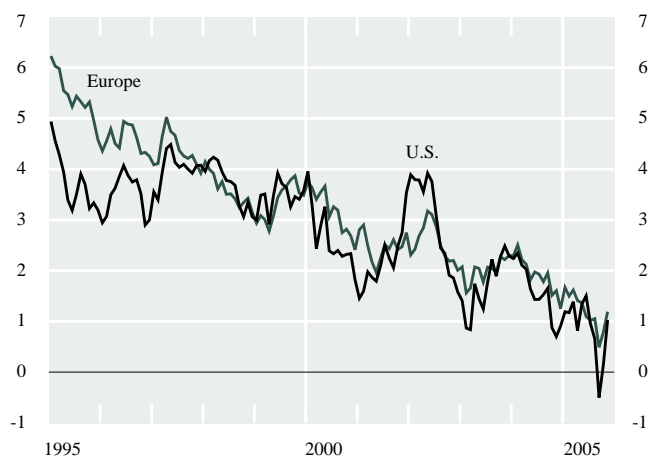
Traditionally, developing countries have run current account deficits and used capital imported from wealthier countries to finance their growth. These days, that pattern is reversed: developing countries are running surpluses and exporting capital.

The size of the U.S. draw on the world's pool of savings is worrisome. Savings are the source of the investment capital needed to finance economic growth and development. In recent years, the bulk of internationally mobile global net savings has been channelled to the United States rather than to developing countries, presumably because investors expected better returns in the United States. Traditionally, developing countries have run current account deficits and relied on capital imported from wealthier countries to finance their growth. This was Canada's experience for many decades, and it is consistent with economic theory—investment capital should flow to faster-growing low-income countries from wealthier countries where growth has slowed. These days, however, developing countries—notably China and the oil-exporting countries—are running surpluses and exporting capital, reversing the usual pattern.

Interest rates have assumed an important role in the debate over global imbalances because they represent the crossing point for supply and demand in the global market for capital. More accurately, real interest rates (that is, nominal rates adjusted for expected inflation) reflect the interaction of saving and investment inten-

Chart 5
10-Year Real Yields

Monthly average of weekly closing benchmark yields less year-over-year consumer price index (not seasonally adjusted)



Source: Bloomberg, BoC calculations

tions. If desired saving (the supply of capital) increases more than desired investment (the demand for capital), then the real interest rate—the rental fee for funds and the return on savings, if you like—falls. If inflation rates are roughly the same in most countries, then low interest rates can be interpreted as reflecting an excess of global saving intentions over investment opportunities. Recently, long-bond yields have been remarkably low around the world (Chart 5). This has been particularly perplexing in the United States—former Federal Reserve Board Chairman Alan Greenspan called it a “conundrum”—where a combination of strong economic growth, large fiscal deficits, and sustained tightening of monetary policy through rising short-term official interest rates would normally have resulted in higher yields. From a global perspective, however, low long-bond interest rates, in real terms, can be explained by an “excess” of desired global saving over desired global investment.

The Excess-Savings Story

What, then, is behind these excess savings? Advanced countries, EMES, and oil-producing nations alike have their own reasons to save more. In advanced economies, one important driver appears to be a widespread restructuring of corporate balance sheets following the collapse of stock market bubbles in 2001. Corporate profits are high, yet firms have preferred on the whole to distribute profits, buy back their shares, and reduce

their debt load, rather than invest heavily in new ventures. This relative reluctance to invest reflects several factors. Firms have turned prudent after coming under greater public scrutiny in the wake of corporate scandals. Strategies for spending on information technology equipment have become more cautious following the splurge of overinvestment—extreme in some cases—associated with Y2K and the telecom and dot.com bubbles.

In many industrialized countries (less so in the United States), the story might also involve aging populations. Some countries have been saving more to meet the retirement needs of the baby-boom generation, the oldest of whom have just turned 60. Yet there may be fewer investment opportunities at home in economies that are less dynamic than those with younger populations. Saving has exceeded investment in Japan for the past quarter-century and—to a lesser extent—in the euro area for most of the past 20 years.

EMEs have their own reasons to make a bigger contribution to global savings. Many Asian nations that boomed in the mid-1990s experienced recessions following the currency crises of the late 1990s. Their recovery strategy—chosen freely or out of necessity and often at the urging of the international community—has been to reduce domestic expenditures and generate current account surpluses, making them net suppliers of funds. Even non-crisis countries like China began to accumulate foreign exchange reserves as a precautionary measure. Having been burned themselves, or seen their close neighbours burned, they have built “war chests” of foreign exchange reserves to protect themselves from a sudden outflow of capital. The recent rapid rise in oil prices has also contributed to higher global savings. Oil producers, many of which learned some hard lessons in the 1980s when they squandered their sudden oil wealth, have been unwilling—and to some extent unable—to spend their rising revenues as fast as they accumulate them.

It is possible, then, to argue that low long-term real interest rates can be largely explained by a combination of forces that created a significant increase in the global supply of savings—a “global saving[s] glut,” to use the term popularized by Federal Reserve Board Chairman Ben Bernanke. Broadly speaking, this is the view of the optimists in the global imbalances debate.

This story has some appeal in the United States, because it means the current account deficits can be seen, not in the negative light of U.S. overspending and undersaving, but as a positive reflection of its

greater growth potential and of the lack of investment opportunities outside the United States. The United States is simply buying now (and absorbing more imports) with the prospect of paying later (because the U.S. economy, widely regarded as more productive than most, is likely to grow faster than other industrialized countries in the future). When stock markets crashed in 2001–02, an expansionary monetary policy kept interest rates low and encouraged a surge in the building and buying of homes, which created opportunities for capital gains in the housing market. Rebounding equity markets delivered a further rise in household wealth. These gains, combined with low interest rates, encouraged low private saving at a time when the fiscal balance was deteriorating. In effect, households saw their wealth increasing as their homes appreciated in value, so they saw less need to save.

Financial globalization played a role by facilitating the growth of the U.S. current account deficit in three ways. First, it increased the pool of international savings that could be used to finance the deficit. Second, it reduced the degree of home bias in portfolio investments. Traditionally, most savers invested the bulk of their money in their own countries, so there was a home bias in their financial portfolios. Financial globalization has made it easier and cheaper to invest in foreign assets—always an attraction for investors seeking to diversify their portfolios—while the U.S. productivity “miracle” of the late 1990s (and more recently) generated further interest in investing in the United States. Third, because the U.S. dollar is the dominant international currency, central banks in countries that have been accumulating large current account surpluses have invested much of their increasing international reserves in liquid U.S. Treasury securities.

This is the kernel of the optimists’ view. To the extent that the global imbalances reflect financial globalization, an increased desire to save in countries outside the United States, and the better economic prospects of the United States relative to other industrialized countries, the optimists believe market forces will automatically correct these imbalances over time. In this context, the word imbalance carries no negative connotation.

There is a twist to the story that is peculiar to the United States, which enjoys what some call an “exorbitant privilege” as a result of its central position in the global economic system. The U.S. dollar is the dominant medium for international transactions, the key official reserve currency, the unit of account for

global markets, and the nominal anchor for many economies. This confers the advantage of international seignorage, which some regard as important enough either to render the U.S. current account deficits sustainable or, at least, to postpone the eventual adjustment into the distant future.

Moreover, almost all of the United States' liabilities to foreigners—bonds, stocks, even property—are denominated in U.S. dollars, while the foreign assets held by residents of the United States are denominated in foreign currencies. So when the U.S. dollar falls against other currencies, its net position improves in two ways. First, the lower dollar helps to increase U.S. exports while reducing U.S. imports in the medium term. Second, foreign assets held by U.S. residents rise in value (they are now worth more in U.S. dollars), while the value of U.S. liabilities to foreigners is unaffected (since they are priced in U.S. dollars, they are still worth the same).

For most countries, a current account deficit causes a deterioration in their net foreign asset position. A net creditor country is one whose total current holdings of foreign assets exceed its total current liabilities to foreigners. If it runs a current account deficit in a given year, that shortfall will reduce its net holdings of foreign assets; it may still be in the black, but less so than a year earlier. A net debtor country, on the other hand, is one whose total liabilities exceed its total assets. If it runs a current account deficit, it will go deeper into the red as its net foreign liabilities increase. But in the case of the United States, Gourinchas and Rey (2005a) show that revaluation effects from the changing value of the U.S. dollar have, on average, accounted for about 30 per cent of changes in the net foreign asset position of the United States. That explains how, even though the United States ran deficits averaging almost 5 per cent of GDP over the 2001 to 2004 period, the ratio of U.S. net foreign assets to GDP actually improved.

In addition, the United States has tended to borrow short and lend long during the post-war era, and U.S. investors have mainly invested in higher-yielding equities rather than bonds. The upshot is that the return on U.S. investments abroad is higher than that of foreign investments in the United States. The differential has averaged 3.3 percentage points since 1973 (Gourinchas and Rey 2005b).

The Policy-Failure Story

The pessimists rest their case on five points, which—at the risk of caricature—might be summarized as follows.

First, the imbalances—more specifically the U.S. deficit and the surpluses in China and Japan—reflect either poor policy decisions (the United States) or a lack of initiative in reforming their economic systems (China and Japan). Thus, U.S. government deficits are making the situation worse by reducing national saving. U.S. monetary policy, by keeping interest rates low for a substantial period, encouraged the housing boom that drove home prices higher. Householders who save less because their homes have become more valuable are misleading themselves because housing prices tend to move with income over the long run, and booms can unwind rapidly. Moreover, the United States is attracting the bulk of internationally mobile savings, but these funds are supporting private and public consumption rather than being channelled into productive investment.

Tensions created by the large U.S. trade deficit and the surpluses elsewhere, notably in Asia, are leading to calls for increased trade protectionism to shelter U.S. and European producers from Asian competition.

A second view from the pessimists is that financial markets are confused. Investors and financial analysts, because their perspective is too short, cannot see that the imbalances are unsustainable. In effect, their inexplicable optimism flows from a poor perception of the risks involved, so investors are not pricing risk appropriately. In light of the boom and bust of stock markets in the industrialized countries in the late 1990s and early 2000s, this less charitable view of the wisdom of financial markets cannot be dismissed offhand.

Third, the tensions created by the large U.S. trade deficit and the surpluses elsewhere, notably in China and other Asian countries, are leading to calls for increased trade protectionism to shelter U.S. and European producers from competition from Asia. Many are concerned that the steady gains from the liberalization of international trade since the end of World War II may grind to a halt. This would add to the lack of progress in the latest multilateral trade talks, called the Doha round.

Fourth, if the markets have got it wrong and trade tensions increase, then the risk of a rapid and disorderly correction of the imbalances is that much greater. The fear most often heard is that global investors will grow increasingly unwilling to finance the U.S. deficit at current terms. As a consequence, they will purchase fewer U.S. assets or liquidate part of their U.S.-dollar portfolios. This would lead to higher U.S. interest rates and a lower U.S. dollar. Higher U.S. rates would dampen domestic demand in the United States, while the depreciation of the U.S. dollar would hurt foreign exports to the United States, notably from Japan and Europe. Higher U.S. interest rates, in turn, might dampen the attractiveness of investing in EMEs, causing difficulties around the world. Overall, world economic growth would be considerably weaker.

Finally, adding to the pessimists' anxiety is the fact that policy-makers in the key countries have not acted to reduce these tensions. Their assessment that such inaction will persist leads them to the gloomy conclusion that only a crisis—most likely in the form of a sudden market correction—will resolve the growing imbalances and that the result will be an inevitable period of economic weakness, if not recession.

The Middle Ground

The cautiously optimistic—our third group—remain hopeful that market forces will be allowed to do most of the heavy lifting and that the imbalances will begin to unwind in an orderly fashion, with a gradual decline in the U.S. dollar and a smooth shift of expenditure from the United States to Asia and the oil-exporting countries. But they worry deeply that governments will discourage this development by continuing to maintain policies that get in the way of market forces. On the whole, this has been the view of international organizations that have argued for stronger policy actions by governments, rather than counting on market forces alone to solve the problem.

Although they recognize that major imbalances have persisted longer than expected, despite repeated warnings that they cannot last, these organizations continue to make their case that the imbalances are indeed unsustainable. Rodrigo de Rato, managing director of the IMF, warned recently (2006) that “many features of the economic landscape that seem permanent eventually cease.” He cited the mid-1990s boom in emerging markets and the technology bubble in the United States as cases in point. The OECD takes the view that the U.S. need to borrow from

abroad is driven mainly by the lack of domestic savings in the United States, rather than the robust investment demands of its growing economy. The most fundamental source of low and falling U.S. domestic savings is the household sector, whose saving rate has been dropping since the early 1980s.

For many years, discussions in international forums by heads of state, finance ministers, and governors of central banks have generally pointed to a number of policy measures that could be taken to ease the situation. The United States has been asked to rein in its fiscal deficits. Japan and China have been encouraged to make faster progress on structural reforms, while countries in the euro area have been urged to loosen their labour markets, in both cases to stimulate internal demand. China has been encouraged to accelerate reforms to its financial system and to let its currency float (that is, appreciate), which would reduce its growing trade surpluses; more expensive exports would reduce China's reliance on export-led growth, while cheaper imports would stimulate domestic demand. China has also been advised that a stronger social security system would allow its citizens to save less as a precaution against poor health and a penurious retirement.

Looking Ahead

So far, however, progress has been limited. One reason why policy-makers have shied away from taking strong action is the lack of general agreement on the sustainability of external deficits, particularly in the case of the United States. In practical terms, a current account deficit is sustainable if it can persist over the long run without triggering significant changes in macroeconomic variables (such as a large currency depreciation) or in public policies (such as smaller government deficits or greater protectionist measures) to ensure solvency. A solvent country should maintain a perceived capacity to eventually repay its net foreign debt (with interest) out of future trade surpluses. In effect, a country cannot borrow indefinitely to finance its external debt. Debtor countries must eventually generate trade surpluses, and creditor countries, deficits. The problem is knowing when a country has accumulated too much debt.

This question is especially germane for the United States. Its prominence in the global economics system may delay corrective market forces, so its current account deficits could conceivably continue for some time yet, favouring the accumulation of an excessive level of

net external debt by the United States. Still, it is important to keep in mind that these advantages merely postpone adjustment. An eventual decline in its current account deficit—almost all of which can be attributed to its deficit in the trade of goods and services—is unavoidable, and the longer the United States delays correction, the larger the correction must ultimately be.

How Are Large Current Account Deficits Typically Resolved?

For industrialized countries, current account deficits typically reverse themselves when they reach about 5 per cent of GDP (Freund 2000). It usually takes about three years for the accounts to return to equilibrium, during which time the country's growth slows and the value of its currency drops. Investment falls sharply, while saving in proportion to GDP changes little. At first, the growth of real (inflation-adjusted) imports slows, but over time, it is rising real exports that sustain the improvement. However, it is difficult to draw too many generalizations from the major studies. Depending on the approach, the turnaround in a current account deficit may begin at different thresholds and may require either a large or only moderate depreciation of the currency. Higher interest rates, either as a result of monetary policy interventions or investor concern, may trigger the reversal. The analysis of the contribution of fiscal policy to the current account deficit is inconclusive. It does seem, however, that economic growth must slow, and investment is often the prime mover.

There are enough uncertainties to make predictions difficult, but it is reasonably safe to say that the U.S. current account deficit has already crossed historical thresholds by a significant margin, and that the correction will need to come more from higher household and public savings, which means government deficits will have to fall. Because the current account deficit is associated with strong private consumption and government spending, any further depreciation of the U.S. dollar (it has already fallen by almost 15 per cent since 2002) could be significant. A lower-valued dollar would help to sustain U.S. export growth, while the tightening in U.S. monetary policy that we have seen through higher short-term interest rates should encourage more domestic saving. However, long rates have not moved in tandem. This suggests that a possible trigger for any correction will be a growing reluctance by foreign investors to increase their holdings of U.S. assets. The U.S. current account deficit, then, will not

be corrected by U.S. action alone, but will require some reduction in saving by the surplus countries, which, in turn, will require them to raise their domestic consumption.

This does not dismiss the possibility that a rapid and disruptive correction could begin in the United States with what the IMF's de Rato (2006) recently called "an abrupt fall in the rate of consumption growth in the United States, which has been holding up the world economy." In this case, the trigger could be a combination of slowing growth in house prices and a desire by U.S. consumers to save more, a possibility that has worried forecasters for some time now. The danger, as de Rato put it, is that a sudden slowing of U.S. consumption could "take away a major support from world demand before other supports are in place."

What Must the Surplus Countries Do?

Countries running surpluses must invigorate their own domestic economies so they can make a bigger contribution to global growth rather than relying on the United States to keep the global economy moving.

Many of the countries with current account surpluses have been criticized no less than the United States for policy failures that have encouraged the buildup of surpluses and dampened the domestic demand that will be needed to prop up the world economy if U.S. demand falters. A common theme is that countries running surpluses must invigorate their own domestic economies so they can make a bigger contribution to global growth rather than relying on the United States to keep the global economy moving. Japan and Europe have been urged to carry out structural reforms to reduce rigidities in their product and labour markets. China has been criticized for tightly managing its exchange rate when its surpluses would drive a floating currency much higher. Although China last year allowed its currency to appreciate by 2.1 per cent and has taken other moves to promote flexibility in its capital markets, international organizations continue to recommend broader policy reforms—not only in China, but in other emerging Asian countries as well—to

encourage faster growth in domestic demand and greater exchange rate flexibility. Oil-producing countries have been urged to mop up some of their surpluses by investing more at home; in many cases, there is a pressing need to expand and modernize production infrastructure, so there is no lack of opportunities for such investment.

Implications for Growth

How these imbalances are resolved is important for global economic growth—and for Canada. A decline in the U.S. current account deficit requires more saving in the United States, and this would come at the expense of consumption, the largest source of demand in the U.S. economy. And since the U.S. economy accounts for more than one-fifth of the world economy, a slowdown there would affect all countries. For the global economy to keep growing at a healthy clip, other countries would have to pick up the slack. Faster growth in the major industrialized countries—especially Europe and Japan—would help, but would not be enough. The surplus-holding countries of Asia and the oil-producing countries will have to make a major contribution to world economic activity by spending more and saving less, which would reduce their current account surpluses.

Market forces will encourage this shift, and while a smooth and orderly transition remains the most likely

outcome, the risk remains that it will be sudden and disorderly. Financial markets especially have a history of rapidly changing direction in response to changing assessments of risk. When that happens—a recent example is the 1997–98 currency crisis in Asia that spread to Russia and Argentina—the outcome can be damaging and extend well beyond the original source. Financial markets often overshoot, pushing a trend beyond its reasonable, or sustainable, limits; just as often, the reversal to correct that error overshoots in the opposite direction. The longer the current global imbalances last and the greater they become, the greater the risk of an extreme reversal.

This risk could be lessened if governments adopted policies designed to encourage balanced domestic economic growth. A range of policies would be useful: a focus on sustainable ratios of public debt to GDP; the promotion of flexible markets for goods, services, labour, and capital; the development of strong social safety nets that would reduce the need for individual citizens to save large sums as a precaution against job loss, illness, and penury in old age; and the development of financial systems that can offer companies and households appropriate access to credit. They could also move to more flexible exchange rate regimes that would lessen the threat of protectionist trade measures and encourage economic adjustment at home.

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