



BREAKING UP IS HARD TO DO: GLOBAL CO-DEPENDENCY, COLLECTIVE ACTION, AND THE CHALLENGES OF GLOBAL ADJUSTMENT

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Global imbalances have continued, indeed deepened, far longer than both researchers and pundits would have thought. On the US side, the current account deficit at about \$630 billion (2004q1-3, AR) and 5.5 percent of GDP (2004q3) falls outside the oft-quoted range of 4-5 percent after which, research on industrial countries suggests, economic forces tend to narrow the imbalance. There is somewhat less research on the persistence of global imbalances from the standpoint of the rest of the world, in part because individually most of those imbalances are not so notable. Clearly though, collectively growth in the rest of the world has come to be co-dependent on US demand patterns.

Three frameworks for analysis

There are several frameworks to analyze these imbalances. The first framework analyzes the external imbalances from the standpoint of export and import flows. Second, underlying the external imbalances are internal imbalances in both countries and regions with respect to savings and investment, that is, domestic demand and production. Third, these real-side imbalances are reflected in the composition and distribution of financial portfolios of assets and supported through exchange rate regimes. Thus there are three frameworks in which to analyze global imbalances: the international framework (trade and current account imbalances); the domestic framework (savings vs. investment and domestic

demand vs. production); and the financial framework (investor choice over portfolios of assets).

Regardless of the exact point where economic forces push back hard, few suggest that the trajectories for the US imbalances (international, domestic, and financial) are sustainable, although which of the trajectories bites first is open to contention. And neither is the collective path for the rest-of-the-world. That no other country faces as significant a quantitative change to their trade balance as the United States should not imply ease of adjustment. In fact, just the opposite could be the case as each country, facing the policy choices and structural challenges to reorienting demand, production, and financing, could argue that someone else should 'go first'.

In fact, beginning in 2002, the dollar started to depreciate, most notably against the euro, in effect forcing the Euro-area countries to start the process of adjustment of global trade and domestic demand. However, for a second block of currencies in Asia, currency market forces are more muted. For them, a coordinated action to allow internal and external adjustment may be necessary to break-up the global co-dependency and return global growth to a more balanced footing.

In sum, the collective co-dependency between the US and the rest-of-the world has enabled the international, domestic, and financial global imbalances to persist longer than they otherwise would have. Although the dollar began a generalized depreciation in 2002, suggestive that a break-up of the global co-dependents was underway, the distribution of the depreciation has been uneven in ways consistent with macroeconomic frameworks of analysis. Breaking-up is hard to do, particularly if that involves collective action on the part of some policy makers.

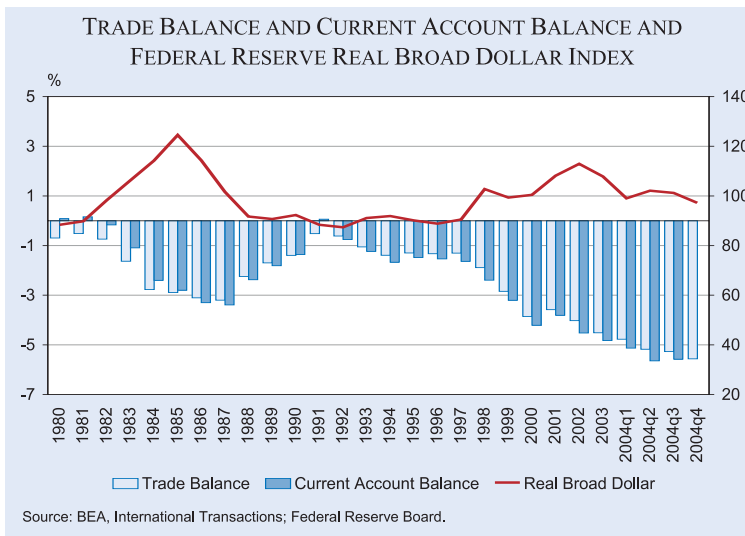
Global imbalance from the perspective of the international framework

The US current account is driven predominantly by trade in goods and services, which in turn is largely determined by US and foreign income growth, along

Which of the trajectories (international, domestic, and financial) will bite first?

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Figure 1



with relative prices. With respect to growth differentials, movements in the US trade balance have been influenced largely by the degree to which the US and foreign economic cycles are out of sync. In the early 1980s, and again in the early 1990s, the US economy slipped into recession and imports slowed. During those cycles, world growth remained relatively robust, so US exports rose. The trade deficit narrowed from both the import and the export side.

During the mid-and late 1990s, the US current account widened as relatively anemic consumption and particularly investment growth in Japan, Europe and other markets around the world dampened demand for US exports while US consumption and investment grew at unprecedented rates and drew in imports. Since the 2001 downturn, US growth has rebounded more quickly than did growth in the rest of the world. Moreover, until several years ago, not only did growth differentials support a widening US external deficit, but also relative prices (as proxied by the real exchange value of the dollar) tended to augment the deficit by making imports cheaper and exports more expensive. Consequently, the US trade and current account deficits have widened into unprecedented territory, both in dollar terms and as a share of GDP (Fig. 1)

The macro picture of the US trade deficit masks important features of the disaggregated

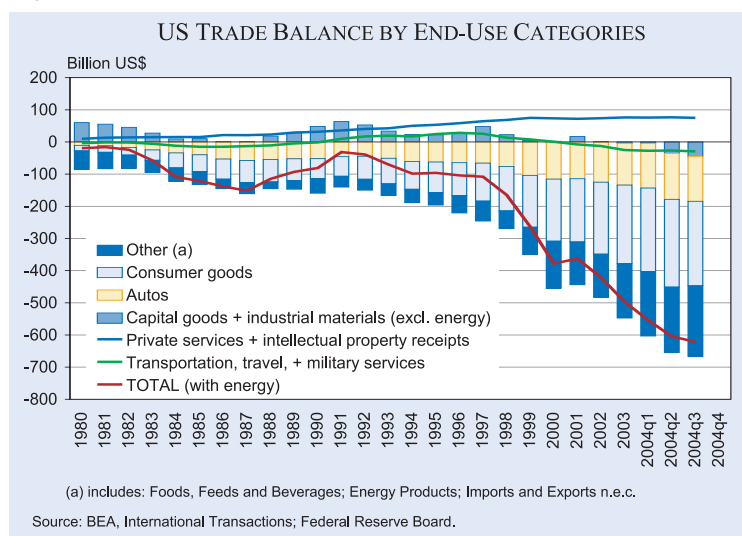
data, which may be particularly important for the advent and resolution of global co-dependency (Fig. 2). The largest category on both sides of the US trade equation is capital goods and industrial supplies and materials excluding energy, which accounted for 45 percent of exports and 32 percent of imports (2004). Up until 1997, net trade cycled through larger and smaller surpluses depending in large part on the US and global business cycles. Since about that time, however, the trade balance in this category has not recovered even as global growth

has revived. From a surplus of about \$50 billion in 1997, this balance is now in deficit to the tune of some \$50 billion. This change may reflect the initial and continued effects of the appreciation of the dollar. It may be due to relatively slow growth of investment in US exporters' markets abroad, which has been masked by more robust aggregated measures of economic activity such as GDP. Given the share of exports, tepid investment abroad would weigh more heavily on US exports of capital goods than on US trade overall. Or, there may have been a permanent change in the international supply chain for the production of capital goods, perhaps to center on China. Or, the fallout from the Asian financial crises may be persisting.

On the other hand, US 'other private services' such as education, finance, and business and professional

Capital goods and industrial materials is the largest category on both sides of the trade equation

Figure 2



services continue to reveal international competitiveness. The balance on trade in this category of trade (which now accounts for 6 percent of total imports and 13 percent of total exports) is positive and has continued to rise despite slow growth abroad. This is particularly impressive given that empirical analysis of the income elasticity of trade in services indicates that sluggish growth abroad disproportionately tends to hold down exports of these services.

Although capital goods and services may be the biggest categories of trade flows, the biggest component of the non-oil/non-agriculture trade deficit is in consumer goods, which account for 21 percent of imports and 8 percent of exports. When added to the net deficit in autos, nearly three-quarters of the increase in the non-oil/non-agriculture trade deficit since 1997 can be accounted for by these two categories of personal consumption expenditures. Moreover, only outright recession (in 1991 and 2001) stemmed the widening in these components of net trade. For some goods (such as apparel, shoes, and computer peripherals) a story of lost comparative advantage is plausible. But, for the full range of consumer and automotive products it does not seem to square with the historical comparative advantage in manufactured capital goods.

Overall, US trade evidences the empirical regularity that US imports grow relatively faster when US GDP grows as compared to how much US exports grow when foreign GDP grows. This empirical finding has several potential foundations ranging from level of economic development in the United States vs. other countries, to love of variety of goods (including of imports from home by immigrants), to trade protection (particularly in services activities), to importance of scale in production. In addition, the very large structural imbalances in the consumer categories of trade may be a reflection of domestic

Current account balances as percentage of GDP, selected regions

	1980	1985	1990	1998	2003	2004	2005p
China	0.1	-3.7	3.1	3.3	3.2	2.4	2.8
Japan	-1	3.8	1.4	3	3.2	3.4	3.2
Asia/Pacific	-3	-0.4	-0.6	4.5	5	4.1	3.5
Western Europe	-1.3	0.6	-0.3	1.1	0.8	1.2	1.3
Australia	-2.7	-5.1	-5.2	-5	-5.9	-5.3	-4.9

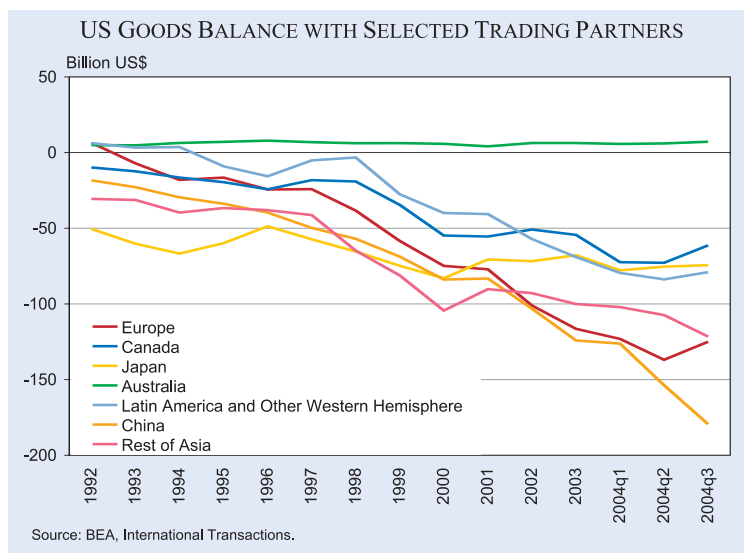
Source: IMF WEO, September 2004.

imbalance in the United States, to which we turn in the next section.

For the rest of the world, what does the international framework for analyzing global imbalances tell us? Considering a 25-year horizon, some regions and countries tend toward persistent current account surplus (Japan) and some tend toward deficit (Latin America and Caribbean and Australia and Canada, not shown). However, during the 1990s, almost all countries moved toward current account surplus, in some cases dramatically so (Latin American and Caribbean, non-Japan Asia, Western Europe, and Canada). So, the widening of the US current account deficit has a counterpart in narrowing deficits and widening surpluses in other parts of the world (Table). These rising surpluses do not necessarily imply a co-dependency on the United States for growth.

However, when countries' global current accounts are examined more narrowly through the lens of bilateral trade with the United States, the dependency on US markets is dramatic. Over all countries and regions, there are large, and in most cases

Figure 3



Bilateral trade balances highlight the dependency on US markets

increasing, trade surpluses vis-à-vis the United States (Fig. 3). The widening US trade imbalance is not just due to imports from China or Japan, but is broad-based across all trading partners. Indeed, the worsening of the bilateral US trade balance vis-a-vis Western Europe is of about the same dollar magnitude as with China (1997 to 2004). (However, note the different behavior of the bilateral deficits for the recent quarters of 2004 – with Western Europe and Canada turning toward balance and Japan leveling off – an observation to which we will return.) Hence, even as the global current account imbalances of the rest-of-the-world are individually relatively small, and hence would not appear to warrant much policy attention, their dependence on the US market for the bulk of the positive improvement in their global current account is quite great and does warrant policy consideration.

An alternative presentation of trade data puts China at the center and shows that the region's growth success is still dependent on the US market. Figure 4 suggests that China is a value-added weigh-station for production ultimately destined for the United States and to a lesser extent Western Europe. To some degree the explosion in intra-regional trade in Asia is not from 'home grown'

Figure 4

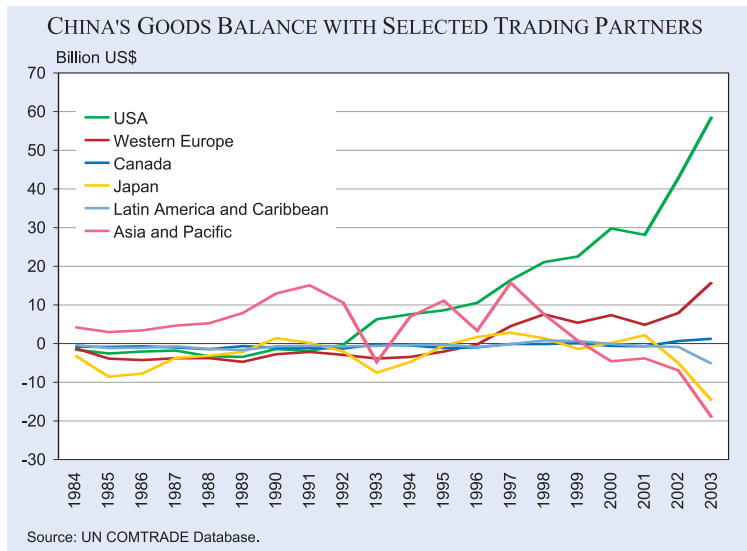
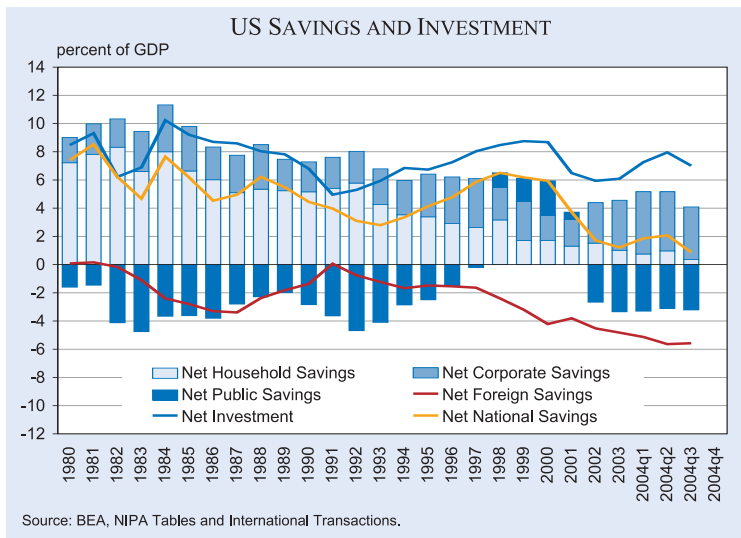


Figure 5



demand, but rather still depends ultimately on exporting to the US market.

Global imbalances from the perspective of the domestic framework

As is well known from national income and product accounting, an external deficit has as its counterpart an imbalance between savings and investment, or, equivalently, between production and domestic demand. How are the US current account deficit and the rest-of-world current account surpluses reflected in their domestic accounts?

For the United States, Figure 5 shows a decomposition of the national income and product accounts into the savings-investment balance, with the components of net national savings highlighted. During the 1990s, the narrowing of the fiscal budget, ultimately into surplus, helped finance the increase in investment of that period. In the last several years the fiscal position returned to deficit with about half to two-thirds of the increase in the deficit due to significant tax cuts to individuals. As investment rebounded, with insufficient national savings, net foreign savings (proxied by the current account) increased. The most notable structural feature of the national accounts is how private consumption in the

As domestic investment rebounded, with insufficient national savings, net foreign savings took up the slack

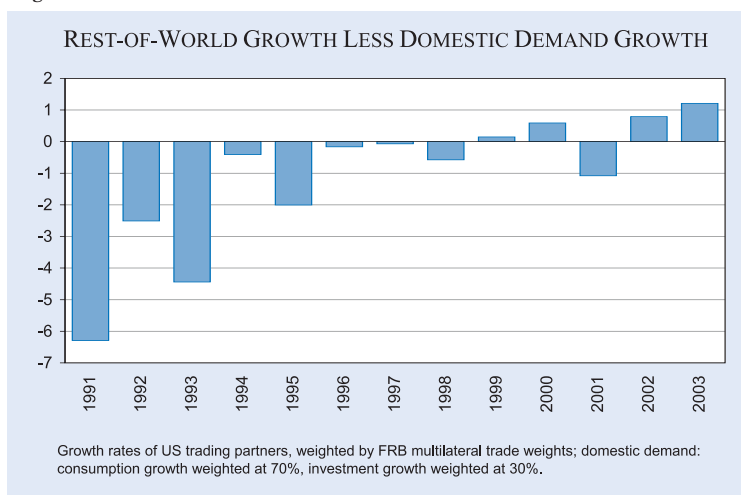
United States has been robust through periods of both fiscal surplus and fiscal deficit; net household savings has trended downward almost without pause.

Matching-up the domestic and international perspectives for the United States, the trending down of household savings in the domestic framework is reflected in a persistent widening of the deficits in the consumer goods and autos categories in the international framework. Policy choices and economic outcomes have augmented US consumption capability, at various times through equity wealth, housing wealth, and tax cuts.

For the rest of the world, the domestic framework for analyzing the global imbalance considers the difference between growth in domestic demand and growth in production. It is common to use growth in GDP as the measure of global economic activity; and this is correct when the objective is to measure global growth. However, when considering global imbalances between the U.S. and the rest of the world, it is important to net out the United States from the global growth equation. Moreover, to the extent that growth in GDP abroad is augmented by a positive net export position, as has already been observed in the systematic move toward current account surplus, growth in foreign GDP will tend to exceed growth in domestic demand. Finally, given the unbalanced composition of US trade, with exports of capital goods being five times more important than exports of consumer goods, considering the break-down of foreign domestic demand between consumption growth and investment growth may be an important link between the international framework and the domestic framework for analyzing global imbalances.

In fact, there was a systematic trend over the 1990s in the relationship between domestic demand growth and GDP growth for countries other than the United States (Fig. 6). Whereas in the early 1990s, non-US global GDP growth was less than non-US domestic demand growth, by the end of the 1990s and to 2003, foreign domestic demand growth fell short of foreign GDP growth by more than 1 percentage point. This unbroken trend narrowing of the

Figure 6



gap between non-US global production and non-US global domestic demand is the striking counterpart to the widening US current account deficit and helps explain the region-by-region net-export surpluses with the United States.

Global imbalances from the perspective of the financial market framework

The third perspective on global imbalances is international financial flows. By the nature of balance of payments accounting, a current account deficit implies net financial inflows from the rest of the world. For the United States, these financial inflows have changed in both magnitude and composition in recent years. Moreover, the extended period of US current account deficits (more than 25 years) implies a build-up of net financial obligations to the rest of the world whose composition and geographic concentration also have changed. The concentration and composition of financial portfolios in the United States and abroad may affect the pace and nature of the resolution of the global imbalances, particularly with regard to the need for coordinated or collective action by policymakers in Asia.

The US financial market offers a wide menu of assets: US Treasury securities, corporate stocks and bonds, direct ownership of a controlling interest in companies or real estate (foreign direct investment), even currency. The patterns and magnitudes of net purchases of these assets reflect broad trends in the financial marketplace. Foreign purchases of US assets regularly exceed the 'financing need' based on the US current account because US investors purchase assets from abroad. For example in the first

The counterpart to the US current account deficit is the gap between foreign domestic demand growth and foreign GDP growth

three quarters of 2004 (AR), the current account was \$640 billion but the financial inflow was \$1334 billion. Equity purchases were particularly notable during the stock-market boom years, and the share of US assets in equity portfolios abroad rose from 30 percent in 1993 to about 50 percent at the end of 2004 (Economist magazine 'Portfolio Poll'). Private and official purchases of US government securities resumed when the fiscal budget deficit reappeared and widened dramatically, thus creating renewed net supply of these assets. Indeed foreigners increased their share of US Treasury securities held by the public from 20 percent in 1990 to 30 percent in 2000 to about 55 percent in 2004.

Foreign official purchases of US Treasury securities have been particularly notable since 2002 when the dollar started to depreciate. Foreign official purchases during times of dollar depreciation are not new. Important foreign official purchases appeared in 1986 to 1989 and again in the mid 1990s, times when the dollar was experiencing depreciation pressures. However, official purchases accelerated during 2003 and 2004, and are unprecedented in terms of dollar value and as a share of total financial inflow. These foreign official purchases are concentrated by holder, with the share of Japanese official holdings in total estimated official holdings rising from 28 to 37 percent between 2000 and 2004 and the estimated share of holdings by China and Hong Kong, SAR rising from 16 to 20 percent of total estimated official holdings (Fig. 7).

For the United States, the accumulation of current account deficits yields an increase in the negative net international investment position, which totaled

\$2.4 trillion as of 2003 (direct investment at current cost). Gross assets (US-owned foreign assets) and liabilities (foreign-owned US assets) are, of course much larger at \$7.2 trillion and \$9.6 trillion respectively.

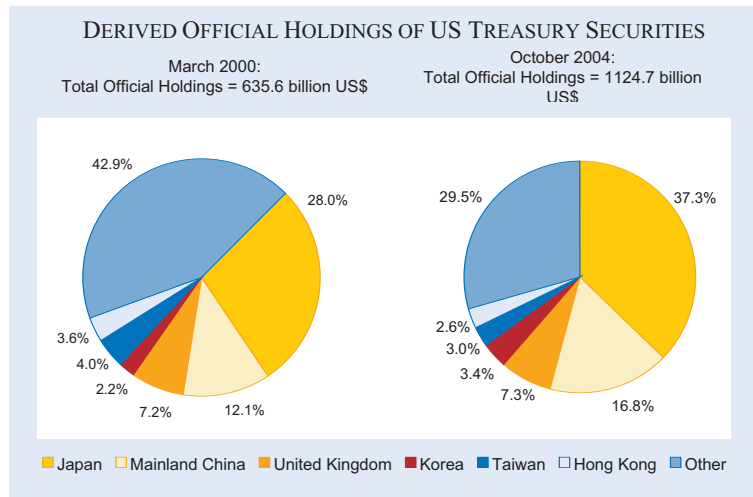
US obligations have several unique features. First, US international borrowing is mostly in dollar denominated financial instruments, so a dollar depreciation reduces the value of the debt. Second, earnings on US direct investments abroad regularly have exceeded the returns that foreigners get on their direct investments in the US. Hence the United States continues to receive net interest receipts (running at an annual rate of \$30 billion for the first three quarters of 2004) despite having a negative net investment position. On the other hand, 65 percent of the financial assets held by foreigners are interest-bearing instruments (including US Treasury securities) whereas only 45 percent of financial assets held by US investors abroad bear interest. This imbalance in financial holdings may increase the exposure of the United States to rising interest rates.

Medium-term concerns: Interest rate and exchange rate vulnerability

The previous sections have outlined the nature of global macroeconomic imbalances. This section focuses on potential vulnerabilities that might result from these imbalances, in particular, to interest rate and exchange rate changes. I will take as given that there are upward pressures on global interest rates and depreciation pressures facing the dollar. These are not incontrovertible, but seem a plausible direction to proceed.

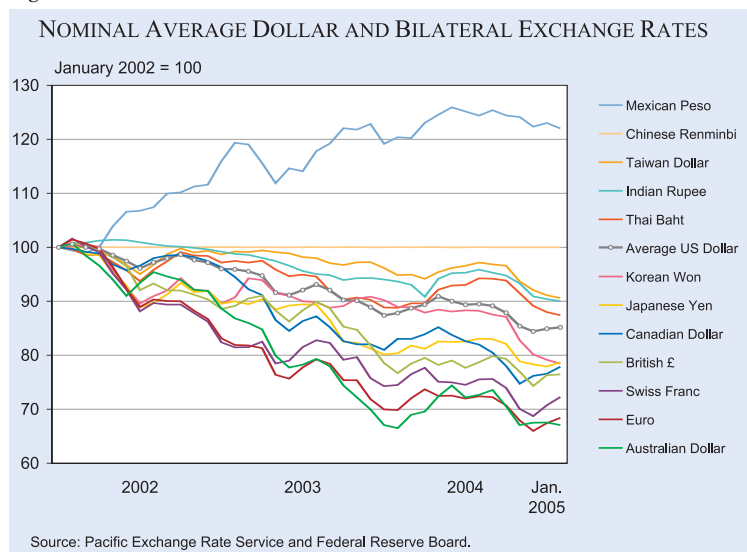
The foreign share of US treasury securities has increased to over 50 percent

Figure 7



The US imbalances to current account, domestic accounts, and financial account suggest two opposing vulnerabilities to rising interest rates and a depreciating dollar. On the one hand, the US negative net international investment position (and its decomposition into interest-bearing and non-interest bearing components) points to an increased vulnerability to rising interest rates. Higher interest rates should add net interest payments to the trade deficit and widen the current account deficit (even though the interest component is posi-

Figure 8



tive now). But, since most US obligations are dollar-denominated, a depreciation of the dollar will reduce the principal value of the obligations. Without a doubt, all else unchanged, financial payments associated with higher interest rates would raise the fiscal deficit (and reduce national savings). On the other hand, higher interest rates and a depreciated dollar are likely to reduce the magnitude of the trade deficit by slowing domestic demand and switching expenditure towards home goods and services and by increasing demand for exports. On balance, the United States faces a variety of adjustment challenges, but they do not go all in the same direction.

For the rest of the world, what kind of vulnerabilities do other countries face from a depreciating dollar? In general, the countries that have purchased US assets are likely to see a capital loss on those assets, both on account of currency valuation and on account of lower prices on assets with fixed interest coupons. At the same time, countries may see a reduction in exports to the United States, as well as have the opportunity to buy cheaper imports, associated with the switch from export-oriented GDP growth to domestic-demand-based GDP growth. So, for the countries in surplus and with large holdings of US assets, the adjustment is (even in the case of lower import prices) all one-way.

Over the last two years, some countries have started to absorb some of these changes – breaking up the co-dependency – and others have not. As noted already in the discussion of the financial accounts, some countries have built-up their holdings of US Treasury securities to a far greater degree than oth-

ers. These foreign official purchases of US assets are reflected in different rates of appreciation of individual currencies against the dollar (Fig. 7) and in differential responses in the trade accounts (Fig. 3). Currencies that are traded through liquid private markets (such as the Canadian dollar, British pound, Swiss franc, Australian dollar, and euro) have appreciated some 20 percent (Canada and Japan) to 35 percent (euroland) against the dollar since the beginning of 2002 (when the dollar started a generalized depreciation). For currencies that are not traded

widely or in liquid markets (such as the Taiwan dollar, Thai baht, and of course the Chinese renminbi), official intervention can play an important role in affecting currency price and their appreciation has been less or none (China).

Based on the movements in current account balances, in net exports to the United States, in purchases of US Treasury securities, and in arrested depreciation against the US dollar, it would seem that some countries have, if anything, moved toward increasing their vulnerability to changes in global interest rates and the exchange value of the dollar. The rationale for this strategy could be an 'insurance policy' should private markets turn against them again (as they did in the Asian financial crises). More generally, the policy choice to limit current appreciation supports the current economic structure and sources of growth (that is, exports relative to domestic demand).

Presumably, these policymakers are doing the calculus to compare the value of economic gains today against the present-discounted-value of (1) future losses on the dollar-denominated asset portfolio should the domestic currency appreciate against the dollar *plus* (2) the presumably rising costs of making real-side adjustments in the source of economic activity from exports to domestic demand. For them, global co-dependency continues to make economic sense. In addition, to the extent that the currencies in the region are bound together by production strategies cemented through direct investment they face a collective action problem. If one country unilaterally breaks out of the currency trend, it bears the brunt of adjustment in the region.

For the U.S., the adjustment challenges do not all go in the same direction, for the rest of the world, the vulnerabilities are rising

With the US current account deficit beyond all historical precedent and with the build-up of US assets in the portfolios of private and official actors, the dollar should be under significant depreciation pressure and indeed it has depreciated from its trade-weighted 2002 peak. However, dollar adjustment alone is unlikely to close the US side of the global imbalance due to the size of the initial imbalance as well as to the lop-sided role of consumption. On the other side, some policymakers abroad, for their own structural reasons to depend on exports to grow, have inhibited an appreciation of their currencies against the dollar, even as others have absorbed substantial currency change. Overall, US adjustment is stymied and, potentially worse, rest-of-world imbalances may be concentrated in regions and official holdings in Asia where there has been the tendency to limit both exchange rate change and structural reorienting of demand. Coordinating a collective move there could aid global internal, external, and financial adjustment.

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