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Current Account Adjustments in a Historical Perspective

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CROATIAN NATIONAL BANK

Current account adjustments in a historical perspective

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Abstract

This paper analyses historical evidence on macroeconomic adjustments to large changes in current account imbalances – both deficits and surpluses. It studies annual data on key macroeconomic variables for seven advanced and six emerging market economies between 1980 and 2011. The analysis confirms that reducing a large deficit lowers growth and employment and vice versa. Reducing a large surplus raises growth and employment and results in better macroeconomic outcomes than increasing the surplus. As the deficit (or surplus) narrows and approaches balance, there is a tendency for the process to reverse and for the imbalance to start widening again. The paper also develops scenarios for international rebalancing over the next few years based on these historical experiences. The analysis suggests that a significant global rebalancing could be already achieved if major economies implemented adjustment measures in line with their own historical experience.

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Introduction

Past decades have seen many episodes of highly disruptive surges and retreats of international capital flows to and from emerging market economies (EMEs). The sovereign debt crisis that followed the global financial crisis of 2008–09 has shown that advanced economies are by no means immune to cutbacks in external financing. Large and persistent current account imbalances are intimately linked to credit and asset price booms, the build-up of domestic imbalances, high debt levels and other vulnerabilities that until recently were mainly associated with developing countries. This suggests the importance of looking at the historical experience of individual economies – both advanced and emerging – when addressing the question of how to reduce current account imbalances at the global level.

This paper takes such a historical approach and analyses over 100 episodes of macroeconomic adjustment to large changes in external imbalances. We study these adjustments in both deficit and surplus countries, using country-specific definitions of “large” current account changes, which are based on time series properties of such changes.

Like the earlier literature, we find evidence of persistence of current account imbalances and of negative effects of current account reversals on real growth. However, most of the earlier literature does not study large changes in current account surpluses, which are perhaps more important from the global perspective at the current juncture. We find that reducing the current account surplus results in macroeconomic outcomes than increasing the surplus. Regarding persistence, we find that, as the deficit (or surplus) narrows and approaches balance, there seems to be a strong tendency for the process to reverse and for the imbalance to start widening again. Reflecting the spread of global finance, the threshold at which external financing becomes a binding constraint on the size of deficits seems to have risen over time. This implies that imbalances may now last longer and their reduction may have become more disruptive than in the past.

We also develop scenarios for international rebalancing over the next few years based on these historical experiences with current account adjustment. We argue that a significant external rebalancing could be achieved already if major economies implemented adjustment measures in line with their own historical experience. However, it is not clear if the incentives for individual countries – deficit countries, but perhaps even more so surplus countries – are strong enough to adopt the policies needed.

The paper is organised as follows. Section 1 sets the stage by reviewing some stylised facts on global imbalances. Section 2 describes the empirical approach and analyses large current account adjustments in the sample of seven advanced and six emerging market economies between 1980 and 2011. Section 3 develops alternative scenarios for global current account rebalancing based on these historical experiences. We conclude with a brief discussion of some policy implications of the results.

1. Some stylised facts on global imbalances

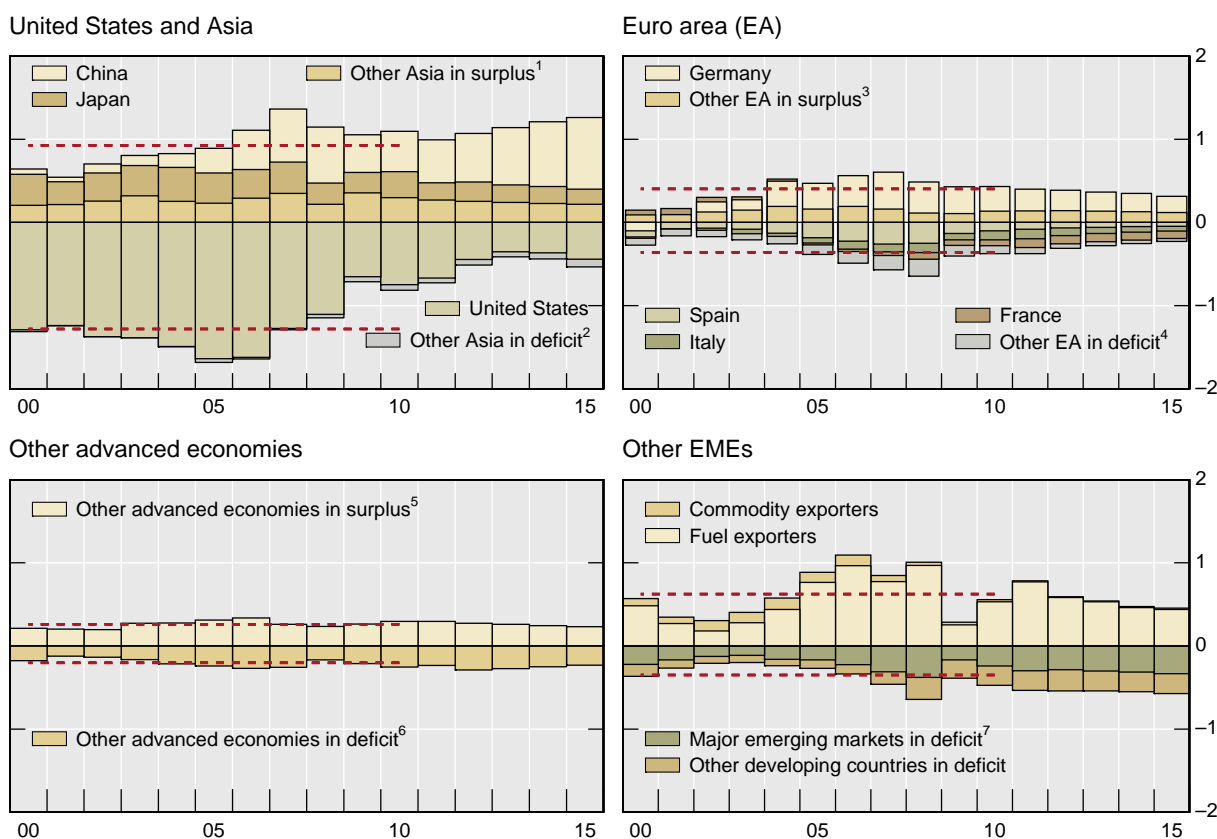
Global current account imbalances – surpluses or deficits – have averaged around 2½% of world GDP each over the past decade. Although it narrowed from the peak of around 3% of world GDP in 2007, the global current account surplus/deficit was still at roughly 2½% in 2011. Current account imbalances are also persistent at the country level. The last time the United States had a current account surplus was in 1981; the United Kingdom in 1983; and Spain in 1986. Japan’s and Switzerland’s last current account deficits date back to 1980; China’s to 1993 and Korea’s to 1997. This raises the obvious question: Why are current account imbalances so persistent?

The traditional explanation is that they are part of the process of economic development: developing economies should be importing capital from advanced economies. Indeed, many large EMEs (including Brazil, India, Mexico, South Africa and Turkey) do run current account deficits. And many advanced economies (including Germany, Japan, Switzerland and Scandinavian countries) are capital exporters.

But this traditional explanation is at odds with some key recent patterns. In particular, several major EMEs (including China, Korea and Southeast Asian economies) continue to run large external surpluses, while several major advanced economies (including Australia, France, Italy, Spain, the United Kingdom and the United States) continue to run substantial deficits.

One explanation for these “uphill” flows is that macroeconomic conditions and economic policies have favoured demand patterns that create them: high consumption in the United States and export-led growth in Asia are the primary examples. This interpretation seems consistent with the patterns we observe. In particular, global imbalances are concentrated in two blocs of economies: first, the United States and Asia (Graph 1, top left-hand panel); and second, commodity and fuel exporters (bottom right-hand panel). A common feature of these two blocs is the use of the US dollar as anchor currency. The combination of monetary accommodation in the United States and resistance to exchange rate appreciation and capital inflows (or moves to manage capital flow volatility) in Asian surplus economies has led to large-scale reserve accumulation and occasional use of capital controls. Combined, these help perpetuate the large external imbalances.

Graph 1
Current account balances, 2000–2015
 As a percentage of world GDP



Red dashed lines denote average values of surpluses and deficits over 2000–10. Data for 2011–2015 are projections from the IMF's September 2011 World Economic Outlook.

¹ Including Chinese Taipei, Hong Kong SAR, Korea, Malaysia, Singapore and Thailand. ² Including India. ³ Austria, Belgium, Finland and the Netherlands. ⁴ Including France, Greece, Italy, Spain and Portugal. ⁵ Denmark, Israel, Norway, Sweden and Switzerland. ⁶ Australia, Canada, New Zealand and the United Kingdom. ⁷ Brazil, Colombia, Mexico, South Africa and Turkey.

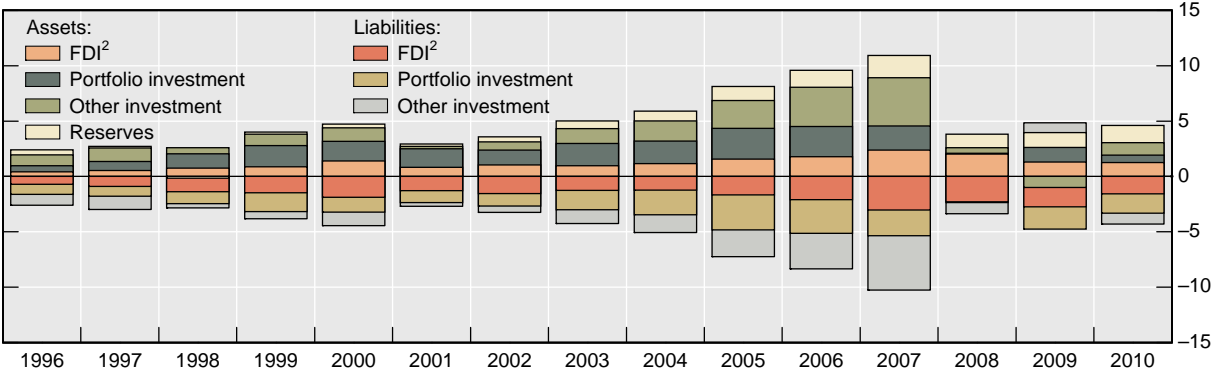
Source: IMF, *World Economic Outlook*.

Within the euro area, the external imbalances also remain large, although they narrowed from pre-crisis peak levels (top right-hand panel). In 2009, deficit countries – including Greece, France, Ireland, Italy, Portugal and Spain – cut their combined deficit by about \$150 billion, to \$230 billion. Much of this reduction reflected the end of an unsustainable credit boom which distorted saving-investment balances. The end of this boom has therefore led to a sustained narrowing of current account deficits to around \$260 billion in 2011, back

to the 2006 level. Similarly, the combination of the global slowdown and greater resilience of domestic demand has reduced the combined current account surplus of Germany, Austria, Finland and the Netherlands to about \$275 billion in 2011 – back to the 2006 level – from a peak of around \$340 billion in 2007.

The period that preceded the global financial crisis was characterised not only by large current account imbalances and the associated *net* capital flows but also by a dramatic expansion of *gross* capital flows. Graph 2 shows that gross flows reached a record level of over 10% of world GDP in 2007. An important part of this increase was due to the expansion of cross-border bank credit, which is included in the category “other investment”. The accumulation of foreign reserves has also added to the increase in gross flows. After declining sharply during the crisis in 2008, gross capital flows have remained relatively high by historical standards, ie around 5% of world GDP. By comparison, during 1980–1995, when gross capital flows were relatively stable, they averaged less than 2% of world GDP.

Graph 2
Global gross capital flows¹
 As a percentage of world GDP



¹ Changes in assets (outflows) and liabilities (inflows) over the period. ² Foreign direct investment.
 Sources: IMF, *International Financial Statistics* and *World Economic Outlook*.

These record gross capital flows have led to an unprecedented expansion of international balance sheets. Gross assets and liabilities rose in the decade prior to the crisis in all major advanced economies (Appendix Graph A1). Except for the United Kingdom and the United States, net IIPs expanded, growing more positive in Germany and Japan and more negative in Italy and Spain. Reflecting its prominent role as a world financial hub, the United Kingdom has the largest *gross* international investment positions among advanced economies, at over six times its GDP in 2010. However, the UK’s *net* IIP is small. One can also notice that the large emerging markets generally have much smaller *gross* IIPs, although their net positions are comparable in size to those of major advanced economies.

Besides raising issues of sustainability, a negative net foreign asset position usually implies a drain on a country’s income, and hence a negative contribution to its current account balance. However, this is not always the case. Despite a net foreign liability position, the United States has large net foreign investment income (around 1% of GDP in 2010). The reason is that payments on US external liabilities (mainly portfolio equity and debt investments) are more than offset by income on the country’s external assets (mainly FDI). In other words, the United States plays the role of an intermediary in the international financial system, selling safe fixed income assets in exchange for riskier equity assets that have higher returns.

Countries with large net foreign asset positions do not necessarily earn large net foreign investment income. For example, China has a net foreign asset position of 30% of GDP, but earns only 0.5% of GDP in net foreign investment income. This is because it pays a relatively high return on direct investments made by foreigners in China, but receives a very low return on the foreign assets – mainly US Treasuries – that it owns. In addition, the return on external assets is exposed to exchange rate risk.

2. Macroeconomic adjustments to large changes in current account imbalances

When addressing the issue of global current account imbalances, it is useful to know how often large changes in current account positions occurred in major economies in the past, and how the key macroeconomic variables adjusted when such changes had occurred.

To provide some empirical evidence on these questions, this section looks at the large changes in current account imbalances for a group of seven advanced and six emerging market economies over the period from 1980 to 2011. The advanced economies in our sample are France, Germany, Italy, Japan, Spain, the United Kingdom and the United States. The EMEs we look at are Brazil, China, India, Korea, Saudi Arabia and Turkey.

The literature uses a variety of definitions of “large” changes in current account imbalances, from simple rules of thumb (eg, 3 percentage points of GDP) to regional benchmarks and model-based estimates (see eg Edwards, 2001). In this paper, a change in the current account to GDP ratio (CA/Y) is considered to be “large” if it is greater than one standard deviation of such changes (increases in deficits, reductions in deficits, etc) in a given country over 1980–2011. The advantage of this measure is that it takes account of structural economic differences across countries – for a commodity exporter a change in the external imbalance of 5–8% of GDP can be relatively small, while for an advanced economy a change of 1½–2% of GDP can already be very large.

Using this definition, there were a total of 119 large changes in the current account in our sample. They are divided into four groups: (i) reductions of deficits (often referred to as current account “reversals”); (ii) reductions of surpluses; (iii) increases in deficits; and (iv) increases in surpluses. Reductions in deficits and surpluses both result in lower imbalances and hence represent shifts towards equilibrium. By contrast, increases in deficits and surpluses result in wider imbalances and imply shifts away from equilibrium.

Table 1 shows average changes in key macroeconomic variables – GDP growth rate (dY); investment rate (I/Y); government budget balance (B/Y); unemployment rate (UE); nominal exchange rate (ER); exports (dX); and imports (dM) – for the years in which the large current account changes occurred.

As can be seen from the first two rows of Table 1, between 1980 and 2011 advanced and EMEs each experienced 20 **large reductions (“reversals”) in external deficits**. In advanced economies, deficit in the year before the reversal was on average 2.7% of GDP; it was reduced by 1.7 percentage points on average, ie to a deficit of 1% of GDP. In emerging markets, the average deficit a year before the reversal was larger (4.2% of GDP) and was reduced by 4½ percentage points on average, ie to a surplus of 0.3% of GDP. These reversals were accompanied by a drop in the GDP growth rate of 0.9 percentage points in advanced economies and 2½ points in EMEs. The investment rate fell on average by 1.8% of GDP in advanced economies and 2.4% in EMEs; and the unemployment rate rose by 1.2 and 0.7 percentage points, respectively.

The adjustment in budget balances was not symmetrical across the two groups of countries: the budget balance widened in advanced economies (on average by 2.6% of GDP) but narrowed in EMEs (by 0.6% of GDP). This suggests that EMEs might face tighter financing constraints than advanced economies, and therefore need to restrain fiscal policy at the same time as they cut the external deficit. The advanced economies, by contrast, can afford to loosen fiscal policy slightly to offset the contractionary effects of cuts in external deficits.

The last three columns of Table 1 show the scale of corresponding adjustment in the external sector: the exchange rate depreciated on average by 4% in advanced economies and 23% in EMEs in the year of the current account reversal; boosting exports by 5.4% in advanced and 8.2% in EMEs; and trimming down imports by 1½% and 5%, respectively.

Large **reductions of surpluses** were less frequent. As shown in the third and fourth rows in Table 1, since 1980 there have been nine cases of big cuts in surpluses in advanced economies and five in EMEs. The advanced economy surpluses were cut on average by 1.4% of GDP, those in EMEs by 3.8%. The bulk of adjustment came through a surge in imports. For current discussions on global rebalancing, it is interesting that neither exports

nor GDP growth collapsed when external surpluses narrowed: GDP growth accelerated on average by 1 percentage point in advanced economies and 2 points in EMEs, while exports expanded by over 6% on average in both groups of countries. The impact on unemployment was small as well. In addition, the accompanying exchange rate appreciation was moderate.

Table 1 **Large changes in current account imbalances¹**

	CA/Y ₋₁	Δ(CA/Y)	Δ(dY)	Δ(I/Y)	Δ(B/Y)	ΔUE	ΔER	dX	dM
	Percentage points							%	%
Deficit reduced									
Advanced economies (20)	-2.7	1.7	-0.9	-1.8	-2.6	1.2	-3.9	5.4	-1.5
Emerging markets (20)	-4.2	4.5	-2.5	-2.4	0.6	0.7	-22.8	8.2	-5.0
Surplus reduced									
Advanced economies (9)	3.0	-1.4	1.1	0.8	0.3	-0.2	2.3	6.2	12.8
Emerging markets (5) ²	5.9	-3.8	2.0	4.2	-0.3	0.0	5.8	6.2	17.4
Deficit increased									
Advanced economies (23)	-0.7	-1.9	1.2	0.5	0.3	-0.5	-0.6	5.0	9.6
Emerging markets (20)	-0.1	-4.6	1.8	2.5	0.2	-0.5	-11.5	4.7	19.1
Surplus increased									
Advanced economies (15)	1.3	1.3	0.4	-1.0	0.1	0.9	-0.9	5.3	2.5
Emerging markets (7)	2.9	4.2	1.1	-1.0	2.9	-0.1	-1.4	13.4	6.6

¹ A change in the current account imbalance to GDP ratio is defined as "large" if it is greater than one standard deviation of such changes in a given country over 1980–2011 (annual observations; data for 2011 are IMF's WEO forecasts). Simple average of countries in each group. Advanced economies: France, Germany, Italy, Japan, Spain, the United Kingdom and the United States; EMEs: Brazil, China, India, Korea, Saudi Arabia and Turkey. Numbers in parentheses denote episodes of large reductions/increases in deficits/surpluses. There are 119 such episodes out of a total of 416 observations. ² Data shown exclude two outlying observations for Saudi Arabia.

Notation: Δ denotes change in a given variable in the year of large reduction/increase of imbalance ("year T") relative to previous year; CA/Y = current account balance/GDP; CA/Y₋₁ = current account balance/GDP in year T-1; dY = GDP growth rate in year T; I/Y = total investment/GDP; B/Y = budget balance/GDP; UE = unemployment rate; ER = nominal exchange rate against USD (for the United States, USD against DEM/EUR); a minus sign indicates depreciation; dX = growth rate of exports (goods and services) volume in year T; dM = growth rate of imports (goods and services) volume in year T.

Sources: IMF, *International Financial Statistics* and *World Economic Outlook*; OECD *World Economic Outlook*, World Bank; national data; Datastream; author's calculations.

The changes of external imbalances that imply shifts away from equilibrium are unfortunately more frequent; they are summarised in the lower half of Table 1. Since 1980, there have been 23 cases of a large **increase in the deficit** in advanced economies and 20 in EMEs, as well as 15 cases of a large increase in the surplus in advanced economies and seven in EMEs. By and large, macroeconomic adjustments to the worsening of external imbalances follow the textbook pattern. When the deficit widens, GDP growth, investment and imports increase; the budget deficit widens; and the exchange rate depreciates. Importantly, however, the unemployment rate falls when the deficit widens – on average by half a percentage point.

In the case of a large **increase in the surplus**, GDP growth increases (though by less than when the deficit widens) and the budget balance improves. However, investment falls and there is no significant effect on unemployment. Like the deficits, current account surpluses are fairly persistent: they get reduced when the surplus rises to around 3% on average in advanced economies and 11% in EMEs, but start rising again when the surplus narrows to around 1½% of GDP in advanced and 3% in emerging market economies.

These results confirm several findings from the earlier literature, which mainly looks at the experience before the 2008–09 crisis, and mainly at reversals of external deficits (eg Edwards, 2004; Milesi-Ferretti and Razin, 2000). These findings include large persistence of current account imbalances; a close relationship between the loss of access to external financing – "sudden stops" of capital flows – and current account reversals; a negative effect

of reversals on real growth; and the ability of countries with more flexible exchange rate regimes to accommodate the macroeconomic shocks stemming from a reversal better than countries with a more rigid exchange rate regime.

However, most of the earlier literature does not study large changes in current account surpluses, which are perhaps more important from the global perspective at the current juncture. The above results suggest that reducing the surplus has been associated with better outcomes in terms of growth and employment than increasing the surplus. In contrast, narrowing the external deficit is typically associated with employment and growth losses. This suggests that, for policymakers focused on reviving growth and employment, the widening of external deficits is, unsurprisingly, a more attractive option than the narrowing of deficits – so long, of course, as external financing is available.

The historical experience also suggests that deficit countries may be forced to adjust even when their external imbalances are relatively small, in the order of 3–4% of GDP. But as the deficit narrows and approaches balance, there seems to be a nearly universal tendency for the process to reverse and the deficit starts to widen again. That said, for some countries, the recent reduction in external deficits appears to be more durable. The end of a long period of rapid credit growth that had distorted saving-investment balances in countries such as Ireland, Spain, the United Kingdom and the United States led to a significant narrowing of their external deficits. In the case of Ireland, the consequence has been a dramatic swing from a deficit of 15% of GDP in 2008 to a surplus of around 4% of GDP in 2011.

Country-level data further suggest that there has been a rise in the threshold at which external financing becomes a constraint on deficits that binds in the short term. In the 1980s and the 1990s, many countries experienced large current account reversals when their deficits were around 2–3% of GDP. By contrast, in the past decade many countries have successfully financed deficits well above of 5% of GDP for several years without reversals. The United States is a special case in this regard because it issues the international reserve currency. Several countries in the euro area were also able to delay adjustment because of the lack of market discipline before the sovereign debt crisis.

3. Scenarios for international rebalancing

The existence of persistent external imbalances does not bode well for global macroeconomic and financial stability. The 2008–09 crisis demonstrated, among other things, that even advanced economies in a monetary union cannot sustain imbalances indefinitely. In particular, an external financing constraint eventually becomes binding and the ensuing current account reversals result in very disruptive adjustments. This raises the question of scenarios for international rebalancing at the current juncture, when many advanced economies are heavily indebted and some have begun to lose investor confidence.

The future configuration of international balance sheets does not depend only on the evolution of current account imbalances. Valuation changes in the stock of international assets and liabilities also play a role. As the size of balance sheets has risen, these valuation effects have become more important.

Table 2 shows how the change in the net IIP relates to the change in current account balances over time. Although the United States ran record-high current account deficits over the five-year period from 2006 to 2010, totalling 22% of GDP, its net IIP deteriorated only slightly, from –15% of GDP at the end of 2005 to –17% by end-2010. The reason is that the valuation of the US international assets rose much more than the valuation of its international liabilities. The United Kingdom also benefitted from positive valuation changes: its net IIP improved from –19% of GDP in 2005 to –14% in 2010, even though its current account deficits over this period added up to 13% of GDP.

By contrast, the surplus countries China and Germany experienced net valuation losses on their international assets and liabilities, so that from 2005 to 2010 their net IIP improved by much less than their cumulative current account surpluses. For some other countries, including Spain and India, the valuation effects were small and net IIP changed by almost the same amount as the cumulative deficits over this period.

What happens over the next five years will also depend in part on future valuation changes – bond prices, exchange rates and other asset prices. Nevertheless, a useful baseline approach is to add projected current account balances to calculate the net international investment position on the assumption of no valuation changes. Table 2 adopts this approach to obtain a **baseline scenario** for net IIP of large economies in 2015. This scenario, shown in the yellow-shaded column of Table 2, uses the current account projections from the *World Economic Outlook* of the IMF. Cumulating the projected balances from 2011 to 2015, and adding them to the latest known net IIP (from end-2010), provides estimates of net IIP at the end of 2015.

Table 2	Changes in international investment positions					
	As a percentage of GDP					
	NIIP level in 2005	Cumulative CA balance 2006–10 ¹	NIIP level in 2010		Cumulative CA balance 2011–15 ²	NIIP level in 2015 ³
%GDP			Billion USD			
US	-15	-22	-17	-2,471	-11	-24
Japan	34	18	57	3,088	13	59
Germany	20	31	38	1,252	24	55
UK	-19	-13	-14	-312	-9	-18
Italy	-15	-13	-25	-508	-13	-34
Spain	-53	-38	-90	-1,262	-15	-87
China	18	38	30	1,791	31	42
Brazil	-36	-4	-32	-677	-14	-34
India	-6	-9	-14	-223	-11	-17

¹ Obtained by adding up annual current account/GDP ratios from 2005 to 2010. ² Obtained by adding up projected current account/GDP ratios from 2011 to 2015. ³ Obtained by adding the projected current account balances in US dollars from 2011 to 2015 to the NIIP level in 2010, and dividing by the projected GDP in 2015.

Sources: IMF, *World Economic Outlook*, September 2011; national data; author's calculations.

Under this baseline scenario, the (negative) net IIP of the United States would fall by 7 percentage points, to -24% of GDP in 2015; while the (positive) net IIP for China would increase by 12 percentage points, to 42% of GDP. The largest deterioration in net IIP would be experienced by Italy (to -34% of GDP, from -25% in 2010) and the largest improvement by Germany (to 55% of GDP, from 38% in 2010). The positions of Brazil, India, Japan, Spain and the United Kingdom would remain more or less unchanged.

The baseline scenario thus implies a further widening of some of the largest existing external imbalances – China and the United States on the one side, and Germany and Italy on the other. This reflects, among other things, the assumption that monetary and fiscal policies in most cases would remain broadly unchanged from those in July–August 2011. In the US case, projections are based on more front-loaded discretionary expenditure cuts, a further extension of the payroll tax cut and unemployment benefits, and more delayed revenue-raising measures than incorporated in the president's budget proposal for 2012. Importantly, the *WEO* projections do not include the effects of the latest fiscal measures taken by euro area countries.

The baseline scenario from Table 2 is next compared with two **alternative scenarios** based on the historical experience with large current account adjustments discussed above (see also Speller et al, 2011). Scenario A, shown in the green-shaded column of Table 3, assumes that each country reduces its imbalance in 2012 by an amount equivalent to the historical average of its "good" adjustment episodes between 1980 and 2011, namely deficit reductions for external deficit countries and surplus reductions for external surplus countries. The size of such adjustments is shown in column (a). From 2012 on, the external imbalances are assumed to stay unchanged. As with the baseline scenario, the projected current account balances are then cumulated and added to the net IIP from 2010 to obtain estimates of net IIP in 2015.

Table 3

Scenarios for external adjustment

As a percentage of GDP

	Baseline scenario	Scenarios based on historical current account adjustments			
	NIIP level in 2015 (from Table 2)	(a)	(b)	NIIP level in 2015	
		Average of large reductions in CA deficits/surpluses ¹	Average of large increases in CA deficits/surpluses ¹	Scenario (A) ²	Scenario (B) ³
US	-24	1.3	-0.9	-23	-32
Japan	59	-1.1	0.9	54	62
Germany	55	-1.6	2.1	50	65
UK	-18	1.3	-1.9	-18	-30
Italy	-34	2.4	-1.2	-28	-42
Spain	-87	3.2	-1.8	-79	-99
China	42	-3.9	2.7	25	47
Brazil	-34	3.1	-1.9	-20	-39
India	-17	1.0	-1.1	-14	-21

¹ Amounts shown are historical averages of large current account adjustments in each country over 1980–2011; see Appendix Box A2. ² Deficit/surplus narrows in 2012 by the amount shown in column (a), and stays constant until 2015. ³ Deficit/surplus widens in 2012 by the amount shown in column (b), and stays constant until 2015.

Sources: IMF, *World Economic Outlook*, September 2011; national data; author's calculations.

Under this “good adjustment” scenario, the net IIP of the surplus countries falls significantly relative to the baseline and – in the case of China and Japan – relative to the position in 2010. The net IIP of the deficit countries also improves relative to the baseline, especially in Brazil (by 14 percentage points of GDP), Italy (6 percentage points) and Spain (8 percentage points). In the case of Brazil and Spain, the net IIP in 2015 also improves significantly relative to the position in 2010. This suggests that major external rebalancing could be achieved if countries implemented adjustment measures in line with their own historical experience.

Finally, Scenario B, shown in the red-shaded column of Table 3, assumes that each country widens its imbalance in 2012 by an amount equivalent to the average of its past episodes of large increases in deficits (in external deficit countries) or surpluses (in surplus countries). The size of such adjustments is shown in column (b). From 2012 on, the external imbalances are assumed to stay constant. Under this “bad adjustment” scenario, the net IIP of the deficit countries turns from 4% of GDP (India) to 12% of GDP (Spain and the United Kingdom) more negative than in the baseline. The net IIP of Germany widens by 10 percentage points of GDP and that of China by 5 points. The global economy would thus move further away from external equilibrium.

Concluding remarks

The “good” adjustment scenario discussed above suggests that global current account rebalancing does not necessarily require large changes in the international financial system. Significant external rebalancing could be already achieved if major deficit and surplus countries rebalanced domestic demand in line with their own historical experience.

However, short of a crisis and a cut-off of external financing, how strong are the incentives for countries to adopt the policies needed to rebalance demand? The change in relative prices of tradables and non-tradables that provides incentives for movement of resources in the desired direction is normally achieved through exchange rate adjustment. But that option is not available in a monetary union or a fixed exchange rate regime. A substitute for nominal exchange rate flexibility is then greater flexibility in domestic prices and wages. Reforms that reduce nominal rigidities in product and labour markets can help deficit countries regain competitiveness even if they cannot depreciate their currencies vis-à-vis their trading partners. Likewise, higher wage and price inflation in surplus countries boosts domestic demand and facilitates external rebalancing.

Very high levels of debt in some deficit countries imply, however, that cuts in wages could increase the risk of deflation at the current juncture. And policymakers in surplus countries often find it difficult to break political resistance to the liberalisation of highly regulated non-tradable services and protected tradables such as agriculture. Opening-up such sectors would help boost domestic demand in surplus economies and provide support for exports of deficit countries. Another coordination issue is that exchange rate appreciation in surplus economies is unlikely to happen simultaneously in the countries that are close competitors in international markets: the country that ends up appreciating first risks losing export revenues.

This implies that global current account rebalancing might in the end require some international policy coordination. The historical experience of uncoordinated current account adjustments discussed in this paper is not discouraging. But it does suggest that better outcomes should be possible for both individual countries and the global economy.

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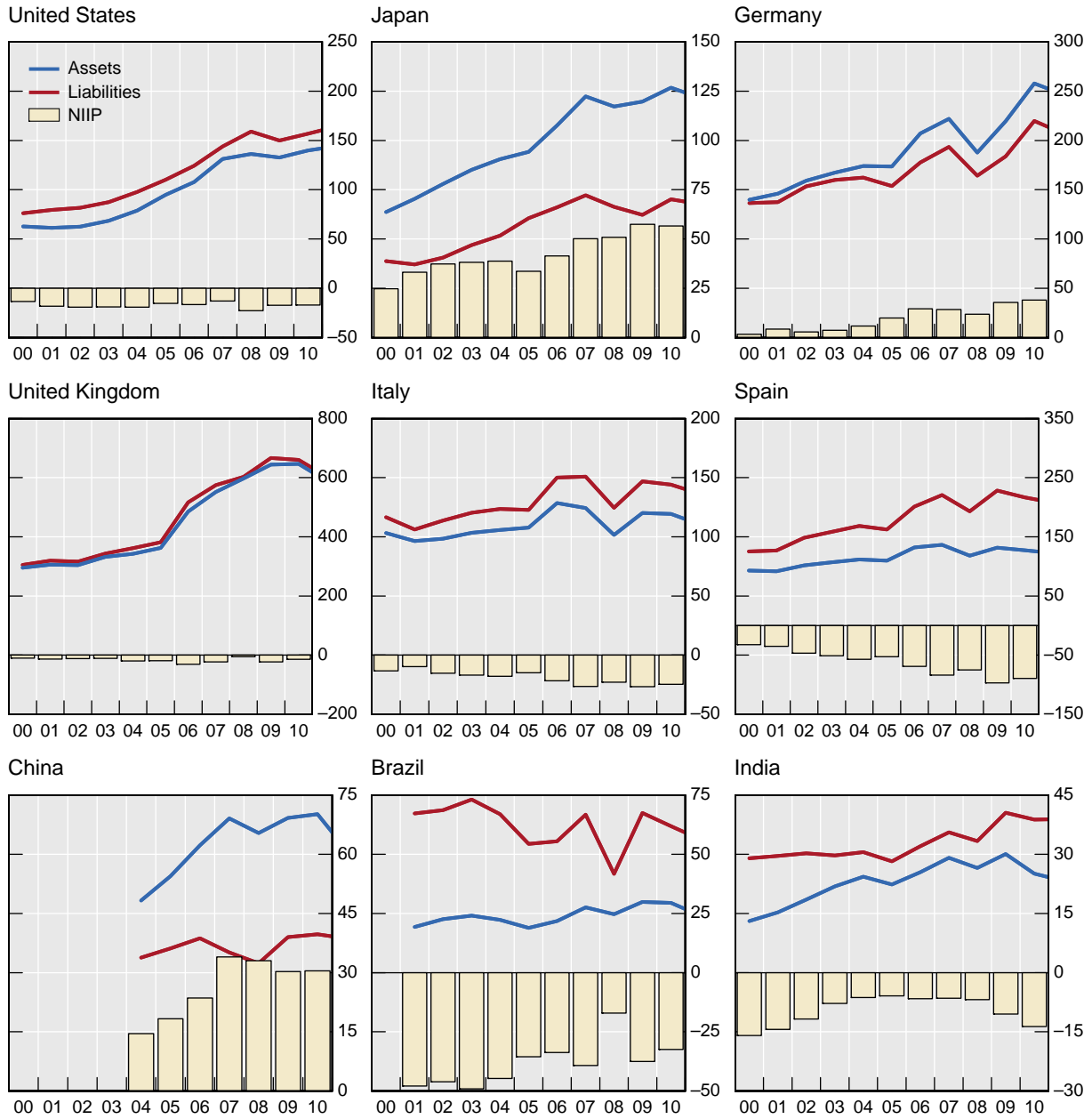
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Graph A1
Net international investment positions (NIIP) of large economies
 As a percentage of GDP



Sources: IMF; national data.