Global imbalances and the international reserve system

Pingfan Hong[1]
Senior Economic Affairs Officer
Department of Economic and Social Affairs
United Nations

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Summary: Policymakers worldwide are primarily concerned about the sustainability of the global imbalances and the implications for the stability of the world economy, but they have not paid enough attention to the implications of the imbalances for the equity and efficiency of the resource allocation across countries. While most analysts mainly focus on the macroeconomic and structural issues associated with imbalances, this article emphasizes the inherent connection between the global imbalances and the flawed international reserve system.

[1] The views expressed in this article are solely those of the author, and they do not necessarily represent the views of the Organization. Contact information:hong@un.org

Global macroeconomic imbalances and the international reserve system

The global economy is unbalanced, featured by a large current account deficit in the United States, which is matched by an aggregate of surpluses in a number of other countries, mainly in Asia and Europe. As the imbalances continue to widen, policymakers worldwide are increasingly concerned about the sustainability of the imbalances, and about the risks associated with various possible ways through which the imbalance will be adjusted for the financial and real economic stability of the world economy; however, the implications of such imbalances are multifaceted for the world economy and for individual economies. More attentions should however also be paid to other implications of the imbalances. For example, even if the imbalances would be sustainable, or even if the imbalances could be adjusted in a smooth manner so that there would be only limited shocks to both the financial markets and the world economy, would such a large magnitude and a skewed distribution of the imbalances really imply an efficient and equitable allocation of global resources across countries? What is the implication of the imbalances for the economic growth of many developing countries in the long run? These questions are equally as important as those regarding the sustainability and stability of the imbalances, but they have not been received adequate attention and policy considerations.

The issue of the global imbalances is also multi-dimensional. It is obviously a trade issue, as the imbalances reflect directly the disequilibrium in the flows of goods and services across countries. It is also a financial issue, as the imbalances indicate a gap in the international capital flows and a difference in the allocation of financial assets across countries. It is an exchange-rate issue, as the imbalances are related to the relative value between currencies: the imbalances can be both the causes and the result of large movements in the exchange rates among various currencies. It is also a macroeconomic policy issue, as across-country differentials in the monetary stance (interest rates) dictate to some extent the direction of various international economic flows while government fiscal positions is directly linked to the imbalances through economic accounts. Without an exaggeration, the global imbalances are inextricably correlated with the across-country disparities in almost all such economic activities as aggregate demand and supply, investment and saving, financial sector and real sector, and the correlation is structural as well as cyclical, and static as well as dynamic.

A large number of studies can be found on the global imbalances, which have either addressed all of these aspects in a systematical approach, or focused on one or two specific areas, for example: United Nations (2004), Blanchard et al (2005), Obstefld and Rogoff (2004) and Mann (2003), but most analysts, except a few, have ignored the fact that the issue about the global imbalances is also indeed a systemic issue. It is a systemic issue for the broad global economic architecture, including the international monetary system, international financial system, and international trade system.

In this short paper, we focus primarily on the connections between the global imbalances and the international reserve system.

A pro-imbalance and pro-asymmetry international reserve system

The inflow and outflow of goods, services, and capitals across national borders do not have to be in balance for every country in all the time. In effect, an appropriate degree of external imbalance is an advantageous feature of the globalizing world economy. For example, when a country is facing an adverse shock, such as a sudden drop in the prices or volume of its exports, it would be desirable for the country to be able to run an external deficit so that the adjustment in the domestic demand would be less severe and less abrupt than otherwise. For many developing countries, meanwhile, it would also be conducive if they could run a certain amount of external deficit financed by a stable inflow of foreign capital so that they could attain an investment growth higher than what is warranted by their domestic savings, thus to expedite their economic development.

Contrary to such a benign scenario, the global imbalances we have observed in reality have more often than not grown to excessive levels, to be followed by destabilizing adjustments.

As shown in the attached figure, the deficit of the United States has prevailed in most part of the past three decades, with only a brief period of balance. Currently, the deficit has reached the record of more than $600 billion, and, as a result, the United States has accumulated a net international debt position of about $3 trillion.

As indicated by many studies, the persistent global imbalances can to a large degree be explained by cross-country structural differentials. For example, a relatively higher growth and lower saving rate of the United States vis-à-vis many other economies are considered to be the primary driving force for a strong import demand of the United States for the foreign goods, and for a continuous accumulation of the dollar-denominated assets by the rest of the world. These differentials are also accentuated by the different stance in macroeconomic, trade and exchange rate policies across countries.

These analyses may, however, be incomplete, and some arguments may sound tautological. For example, The United States being able to run a persistent external deficit may exactly be the cause for, rather than the consequence of, its higher GDP growth than other countries, because the deficit has allowed the United States to benefit from cheaper imports and less costly foreign capital. Therefore, besides these structural explanations, the international institutional arrangements are also important factors behind the excessive, asymmetrical and unstable nature of the global imbalances. We can raise a hypothetic question: if the United States dollar were not the international reserve currency, would the global imbalances be same as they are in terms of its magnitude and the across-country distribution? The answer is likely negative.

The current international reserve system is featured by the use of the national currency of the United States as the major international reserve money, supplemented by the national currencies of a few other major developed countries, with the exchange rates among these currencies floating.

In as early as 1960, Robert Triffin exposed a dilemma facing the international reserve system, namely the Bretton Woods system at that moment.[2] The United States would need to run balance-of-payment deficit to provide the rest of the world with additional liquidity so as to fuel a continued world economic growth; however, when the deficit of the United States expand, excessive dollar would erode confidence in the value of the dollar, weakening its foundation as the world's reserve currency. This inconsistency would lead to a perpetual cycle of expansion and adjustment in the external deficit of the United States, along with instability in the exchange rates and in the output of the world economy.

While Triffin's dilemma seemed to have portended the collapse of the Bretton Woods system, it remains valid for the current arrangement as well, except that the supply of worldwide liquidity via continuous balance-of-payments deficit of the United States is now directly linked to debt-financed excess consumption of this economy rather than to the global investment activities of the large United States firms as in the 1960s, and except that the value of the United States dollar is no longer convertible into a fixed amount of gold. The issuer of the reverse currency is therefore even less fettered from running an external deficit larger than ever.

As the issuer of international reserve money, the United States seems to have the privilege to run a persistently large external deficit.

The United States is able to pay for its international trade and financial transaction in its own currency, needing virtually no foreign-exchange reserves. Moreover, although individual buyers and investors of the United States must forgo certain amount of their

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[2] At the Bretton Woods Conference in 1944 the leading industrial countries established the United States dollar as the principle form of world money. While other currencies were pegged to the dollar, the United States guaranteed the full convertibility of the foreign holdings of the dollar into gold at $35 per ounce. Such as arrangement had been maintained until 1971, when the United States severed the convertibility amid a major dollar crisis, and other currencies abandoned the fixed exchange rates vis-à-vis the dollar.

holdings of the dollar in their overseas purchases, the country as a whole does not have to lose any purchasing power in the process, as the United States Federal Reserve can always print more dollars. By contrast, most other countries in the world have to use the dollar, rather than their national currencies, in their international transaction, and many developing countries are almost always stringently constrained by a shortage of foreign exchange to meet their import demand.

The United States also profits from its role as the world's banker: its liabilities comprise mainly the foreign-exchange reserves accumulated by other countries, usually held in a combination of cash, short-term and liquid (if in longer term) securities paying lower interest rate, while its assets consist of mostly its long-term loans and equity investment in foreign countries, carrying higher interest rate. For example, with a net foreign debt position of about $3 trillion—the holdings of foreign assets by the United States at $7 trillion versus the holdings of the United States assets by foreigners at $10 trillion, the income payment from the United States on its foreign liabilities is still smaller than the income payment it receives from its holdings of the foreign assets, implying a wide yield spread, or the so-called external seigniorage.

The United States also faces much less of external constraints than other countries, as there is virtually no distinction between its foreign debt and domestic debt, all issued in its national currency. The United States can therefore adopt more stimulatory policies than other countries when necessary, such as monetary easing and fiscal expansion, as it did in most recent recession of 2001, as well as in the previous business cycles. In effects, a large proportion of the latest widening in its current account deficit reflects a precipitous swing of its government balance from a surplus to a substantial deficit, partly resulting from a sizable package of fiscal stimuli in recent years and the tax reforms. In contrast, the capacity for running a deficit in many developing countries is limited by their supply of foreign exchange and their access to global credit markets. For example, had a developing country attempted to run such a large external deficit as the United States does, even in relative terms to its GDP, the economy of this developing country would have long been driven into a financial crisis by the punishment of international investors, plus an additional penalty of severe “conditionality” imposed by the international financial institutions.

Some latest economic literature would consider the current international monetary arrangement as a revived Bretton Woods system (Dooley, et al, 2004), with the United States issuing international reserve money, and a group of emerging economies, mainly developing Asian countries, accumulating the reserves. In comparison, in the old Bretton Woods system, a similar pattern was observed between the United States and a group consisting of Europe and Japan. These emerging countries would keep accumulating international reserves issued by the United States so as to maintain undervalued exchange rates, as an integrated measure in their export-led development strategy,

Moreover, by this view, the United States plays a role of international financial intermediation to facilitate growth in the emerging countries. The framework can be considered as implicit international contract, in which the emerging countries promise to pay the United States the total return on the foreign investment in these countries, and in turn, the United States agrees to pay a fixed interest rate on the reserve assets accumulated by the emerging countries. Because the emerging countries are less creditworthy than the United States, i.e. the foreign investment in these countries are riskier than their holdings of the United States Treasuries, the United States should demand collateral from these emerging economies so as to secure this implicit international contract, an analogy to a total return swap in the standard private financial derivative market. In this case, the effective collateral from the emerging countries are exactly the surplus in their current account; conversely, therefore, the United States must run a current account deficit.

These views may have overstretched the analogy of the current international economic arrangement to the Bretton Woods system, as remarked by Eichengreen (2004), who praised such a systemic approach to the analysis of global imbalance, namely, linking the imbalance to the international reserve system, while at same time he pointed out a number of important differences between today’s international economic relations and those of the 1960s. The interpretations and implications in this new literature also remain moot—particularly the implication that the large deficit of the United States is sustainable; however, it seems unequivocal that the global imbalances are inherently rooted in the international reserve system, or more broadly, in the international monetary and financial system.

Adjustment of the global imbalances and reforms of the international reserve system

The privilege and the seigniorage of the issuer of international reserve money should be matched by certain responsibilities. To strike a balance among various roles of the international reserve currency, such as medium of exchange, store of value and unit of account, the United States should maintain a stable value of the dollar while provide the world economy with adequate liquidity. To do so, the United States should avoid running persistently large internal and external deficits to inundate the world economy with excess supplies of the dollar. Otherwise, the issuer would eventually have to face a day of reckoning, and an abrupt adjustment of its deficit will be detrimental not only to the issuer economy but also to the rest of the world.

Historically, the adjustment in the large external deficit of the United States would usually be a bumpy process, accompanied by conspicuous volatility in foreign exchange market and other financial markets, along with a contractionary impact on the growth in both the United States and the rest of the world.

For example, in the 1980s, as shown by chart 6.1, when the current account deficit of the United States reached an unsustainable level, together with an unprecedentedly large government deficit, or the so-called twin deficits, the dollar precipitated drastically in 1985. Until the current account deficit was rebalanced in 1991, the dollar had declined by about 40 per cent against a basket of other major currencies, despite many efforts in international policy coordination among major developed countries, such as the Plaza

Accord of 1985 and the Louvre Accord of 1987.[3] Meanwhile, the equity market in the United States tumbled in 1987. Along with an accelerated adjustment in the deficit, its GDP growth decelerated, falling eventually into a recession in 1991, when the external account reached a balance. Globally, a decline in the growth of many other countries was also obvious during 1989-1991. For example the average GDP growth rate for developing countries in these three years was about half percentage point lower than that of the previous three years, and a decline in the growth of the same magnitude or even larger was observed in many other developed countries.

The rebalancing of the deficit in the United States during the late 1980s was correspondingly matched by an opposite development in the external accounts of many other economies, mainly Germany, a few other developed countries, a number of developing countries in Asia, and some oil-exporting countries. By contrast, the large external surplus in Japan had declined only marginally and was immediately rebounded in the following years, even though yen had appreciated by two-folds against the dollar from mid 1980s to the 1990s. Although some analysts believe global rebalancing, the appreciation of yen in particular, in the late 1980s was directly attributable to the burgeoning financial and real estate bubbles developed in Japan during that period, and to the, subsequently, protracted economic stagnation, many other factors were also at work.

The experience of Japan during the 1980 and the 1990s at least shows that a currency revaluation of a surplus country may not necessarily contribute directly to a meaningful adjustment in the external imbalance: contrary to the conventional wisdom that is still behind the recent advocate for relying solely on the change of exchange rates to adjust the imbalance today.

It is difficult to establish a precise causality between the rebalancing of the external deficit of the United States and the movement in foreign exchange and equity markets, as

[3] While the Plaza Accord might have exacerbated the downturn of the dollar according to some analysts since the accord was aimed to achieve an orderly devaluation of the dollar, the purpose of the Louvre Accord was to stabilize the dollar. For a detailed account of the exchange rate movement and the policy coordination during the late 1980s, see Frankel (1994).

well as the slowdown in global economy during the 1980s and the early 1990s, because a number of other concurrent factors might also be at work, such as the unification of Germany and the Gulf War of 1991; however, the destabilizing and depressing effects of the adjustment for the world economy is arguably significant.

Compared with the 1980s, the global imbalances today have developed larger and longer. Similar to that of the 1980s, the imbalances today are also featured by the large twin deficits of the United States. Unlike that in the 1980s, however, the substantial decline in the equity prices in 2000-2001 with the same magnitude of that in 1987 and the contraction of GDP in 2001 similar to that of the 1991 did not lead to any retreat of the deficit in the United States. While a lag of two years was observed between the beginning of the dollar devaluation and the reversal of the deficit in the 1980s, the lag seems much longer today: it has been four years since the dollar started to depreciate vis-à-vis other major currencies in 2001, but the external deficit continues to widen, implying a deeper and wider "J-curve", which to some extent might also have been compounded by a rise of oil bills for the imports of the United States in the past couple of years.

Meanwhile, some analysts argue that the increasing global economic integration, particularly a deepening global financial integration and a growing international network of production, trade and services, may have made today's imbalances different from that of the 1980s, in terms of sustainability and the implications for the world economy. The difference, however, can only be in quantity, not in quality. These analysts should review the lessons learned most recently from the complacency about the "new economy" right before the burst of the information technology and communication bubbles around 2000: no economic imbalances can permanently sustain the law of economic gravity.

As the imbalances continue to deteriorate, the risks for an abrupt and disorderly reversal have heightened, suggesting an increasing adjustment costs for the world economy in the future, as delineated by various scenarios in many studies, as referred to in United Nations (2000-2005). In addition to all the possible adverse macroeconomic effects as mentioned in these studies, such as those on GDP growth, saving rates, exchange rates, and financial market, the impact of a global rebalance, if goes disorderly, can also be consequentially destructive on the international reserve system per se, or the international monetary and financial system at large. Historically, the debacle of the British pound in the early 1930s, which led to the abdication of the pound as the key reserve currency in the dollar's favour, and the breakdown of the Bretton Woods system in the early 1970s are the vivid attestation for such a systemic risk.

Some analysts believe that unlike the United Kingdom in the 1930s, the economy of the United States remains dominantly strong, and more importantly, unlike the Bretton Woods system, all major currencies are now floating, so there is no "system" to collapse. However, if the large twin deficits in the United States eventually erode the international confidence of the dollar, it can trigger a precipitous shift in the international reserve holdings in many countries from the dollar denominated assets to other currencies, such as euro, and it can entail a substantial capital loss in the reserves of many countries, particularly those developing countries. While such a shift may not be considered as a regime change, as the collapse of the Bretton Woods system, its impact can be equally as significant as, or even more than, that of a regime change.

So far, the concerns about the unsustainable deficit of the United States have mainly been reflected in the foreign exchange market, but not in bond and equity markets yet. The marked decline of the dollar in the foreign exchange market in the past few years has not been accompanied by any measurable sell-offs of the foreign holdings of the United States treasuries and stocks during the same period, as indicated by a flattened yield curve and narrowed spreads in the bond market, as well as a relatively stable equity market. The risk is that this divergent trend between the foreign exchange market and the capital market may be just an anomaly in the short run, and eventually a large relinquishing of the dollar-denominated securities by foreigners may follow, to push up interest rates in the United States, as well as in the global capital market.

Facing the persistent global imbalance, reforms are needed for the international reserve system.

In the short run, while an overhaul of the reserve system is infeasible, measures should be taken to mitigate the risks for an abrupt and unruly adjustment in the global imbalances. First of all, the United States, as the key issuer of the reserve currency, should assume more responsibility for maintaining the stability of the dollar, for example, by consolidating its fiscal deficit. Meanwhile, the surplus countries in Europe and Asia can also adopt more expansionary policies to stimulate their domestic demand. In the context of international reserve and monetary system, a gradual and smooth shift in the international reserve holdings of the dollar-assets to euro and/or other currencies may also be desirable so that the international reserve holdings will be more diversified.

After a decline from 70 per cent in the 1960s to merely above 50 per cent in the early 1990s, the share of the United States dollar in total world official holdings of foreign exchange has rebounded since, standing currently at about 64 per cent. In comparison, the share of euro is less than 20 percent and that of the Japanese yen is less than 5 per cent.[4]

Given the equivalent size of the euro economy to the economy of the United States, it seems feasible for other economies to increase the share of the euro in their foreign exchange reserves while to reduce that of the dollar. In terms of transaction costs and efficiency, some analysts may argue that a single international reserve currency is better than a multi-currency reserve system, but gaining of systemic stability and a more balanced world economy may be worth a trade-off with certain losses in efficiency. Of course, this will require a great effort in the euro economy to be willing to accommodate a stronger role of euro as the reverse currency, including the effort to improve on its regional integration, financial market, and macroeconomic policies, as discussed for example by Kenen (2005).

The SDR issued by the International Monetary Fund (IMF) was originally designed to supplement the United States dollar as a reserve asset. It has later been considered also as

[4] The size of Japan's holdings of foreign exchange reserves, at about $800 billion, is much larger than that of the foreign holdings of Japanese yen as foreign exchange reserves, suggesting that the "net" role of Japanese yen as world currency to provide international liquidity is limited.

a possible substitute for a portion of the dollars already in the reserve portfolio of central banks, but the share of the SDR accounts currently for only about one per cent of the total foreign exchange reserves in the world. Many institutional constraints remain for expanding the role of the SDR, as in Boughton (2001). More detailed discussion of SDR is found in Section 6.7.

The surplus countries may also reduce their total foreign reserves, which in some countries seem to have far exceeded the levels to meet the fundamental needs. Some countries may at the same time consider adopting more flexible exchange rate regime to avoid distortion in the allocation of resources between the external demand and the domestic demand. Meanwhile, some initiatives in the cooperation of regional financial development, such as the Chiang Mai Initiative by a group of Asian countries and the development of Asian bond market, may also lead to more diversification of international reserve portfolios.

Many of these measures to facilitate a smooth global rebalancing require more international policy cooperation and coordination, which are in such paucity currently. The lack of international policy cooperation and coordination could partly be because of a qualified success in the international economic policy coordination in the 1980s. The limited efficacy of the international policy coordination in the 1980s was, however, exactly because the unwillingness of the major economies to sacrifice their national interests in the spirit of international coordination. Given the systemic risks associated with the global imbalance and the existence of externality in national approaches to resolving the imbalance, a submission of certain national interests in the short run may have to be made in order to obtain a better coordinated solution to the global imbalance.

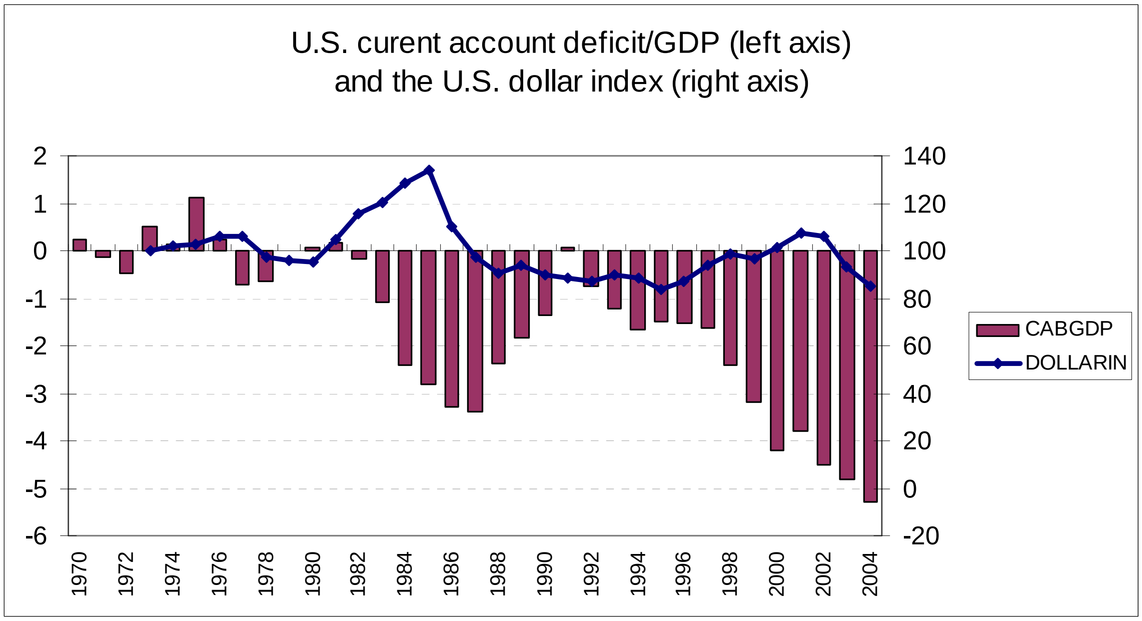
In the longer run, the fundamentally flawed international reserve system and the associated global imbalance problems cannot and should not be fixed by such temporary measures.

Compared to the Bretton Woods system, or the bimetallism in the history, the current international reserve system has a salient merit of flexibility, more expedient for the promotion of international trade and finance, as attested by the rapid global economic integration of the past decade or so. However, such a system can hardly be considered as efficient if it fails recurrently to correct large balance-of-payment disequilibria across countries, if it must entail on many countries, particularly developing countries, a substantial amount of resources as foreign-exchange reserves, which could otherwise be used for domestic production and consumption, and if it constantly involves massive short-term capital flows for speculation and hedge in the foreign exchange market, while the capital could instead be allocated to long-term investment. Nor can the arrangement be deemed as equitable either, when, as the global imbalances imply, the most affluent nation in the world, the United States, absorbs a large proportion of global savings from many developing countries, leaving at the same time a group of the poorest countries in a desperate need for funding their economic development, and when often an adjustment of the global imbalances place heavy burdens asymmetrically on many developing countries. The system also lacks stability as demonstrated by the frequency of international financial crises observed in the recent history and by the volatility in the exchange rates among many currencies.

The current international reserve system is also made on ad hoc basis, hardly a rule-based system at all.

The ultimate goal of reforming the international reserve system should therefore be the creation of a true form of world money. Although such an idea, which has existed for more than one hundred years, still seems to be utopian, the successful issuance of euro—a true form of super-national currency—is a significant step towards this goal. When the condition is ready, individual countries seem to be willing to surrender their sovereignty of issuing national currencies for gaining more economic efficiency, equity and stability. More detailed discussion a true form of world money can be found in Guttmann (1994).

When a world currency is issued outside of the marketplace, instead of using any national currencies, no individual countries will have exclusive benefits or costs from the international reserve system. As a result, although external imbalances across countries will still occur from time to time, the imbalances should become less chronic and the adjustment of it should become less asymmetrical across countries and less deleterious.



U.S. curent account deficit/GDP (left axis)
and the U.S. dollar index (right axis)
2
1
0
-1
-2
-3
-4
-5
-6
140
120
100
80
60
40
20
0
-20
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
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1994
1996
1998
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2002
2004
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