KFW ECONOMIC RESEARCH

KFW

Focus on Economics

No. 44, 5th February 2014

The Problem of Balance of Payment Imbalances

Author: Dr Martin Raschen, phone +49 69 7431-2434, research@KfW.de

With its high current account surplus, Germany, like other countries, is taking a lot of flak. But the deficit countries are also subject to criticism. In the years prior to the onset of the global financial crisis in 2008, current account imbalances again grew considerably worldwide. The Eurozone debt crisis was preceded by a similar development. It is now generally agreed that these imbalances were not taken seriously enough as a warning sign, even though they have long been recognised as potentially heralding a crisis. However, deficits are neither bad per se, nor are surpluses per se good. A deficit may indeed promote development. But the conditions necessary for this are restrictive and often not fulfilled. The lesson from the recent past is thus that renewed excessive imbalances must ultimately be reduced or avoided. While market forces play an important role here, economic policy responses are also required. Each individual case demands its own correct strategy, each problem has its own root causes. In discussions among experts views differ, sometimes to a considerable degree.

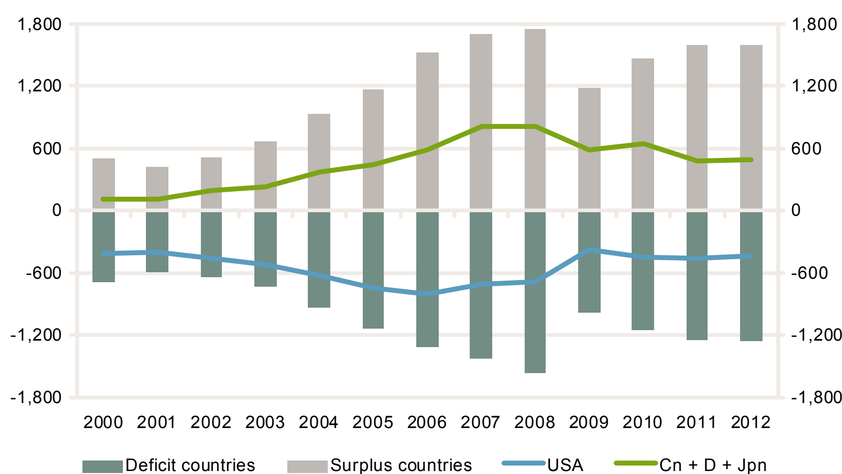
Imbalances as an indicator of crisis?!

A country's transactions outside its own economic territory are recorded in the balance of payments. As the balance of payments is always technically in equilibrium (each outflow of goods from a national economy is balanced against an inflow of goods), the discussion of external account imbalances focuses on subaccounts, and in particular on the current account.[1]

There have always been current account surpluses and – deficits. Since 2000, the imbalances have increased vastly throughout the world. Between 2001 and 2008, the cumulative global current account deficit of the deficit countries rose from USD 587 billion to USD 1,562 billion, while the surplus of the surplus countries increased from USD 418 billion to USD 1,751 billion (see Figure 1). The fact that the balance is not zero is a statistical error.[2] When the global financial crisis erupted in 2008, the USA, Spain, Italy, Greece and France had the highest absolute current account deficits, with the USA alone accounting for 44 % of the total global deficit. Current account deficits may also be observed in many poorer developing countries[3], but at 8 % of the global deficit (2008) their cumulative deficit is of no great importance for the world economy. In 2008, China, Germany and Japan had the greatest absolute surpluses (together these three countries accounted for 46 % of the total surplus), alongside Saudi Arabia and Russia.

In order to identify the significance of a current account balance for an individual country, the ratio between the balance and that country's GDP is determined. China (+7.5 %), Germany (+5.9 %) and the USA (-5.2 %, each the average for 2004 to 2008) merit particular attention since these countries are both very large economies and, as can be seen, have high absolute current account balances. However, it should be noted that these major countries are by no means extreme cases when it comes to the current account balance / GDP indicator. For this indicator, small island states and developing countries have deficits of up to 30 %, but these countries are insignificant in terms of global trade. Their deficits are often structural in nature, meaning that they cannot be meaningfully reduced within a reasonable period through the adoption of "conventional" macroeconomic measures (primarily fiscal and exchange rate policy). Oil exporting countries rank highest among the surplus countries with values of up to 47 %. Their surpluses are highly relevant to the global economy (see Saudi Arabia).

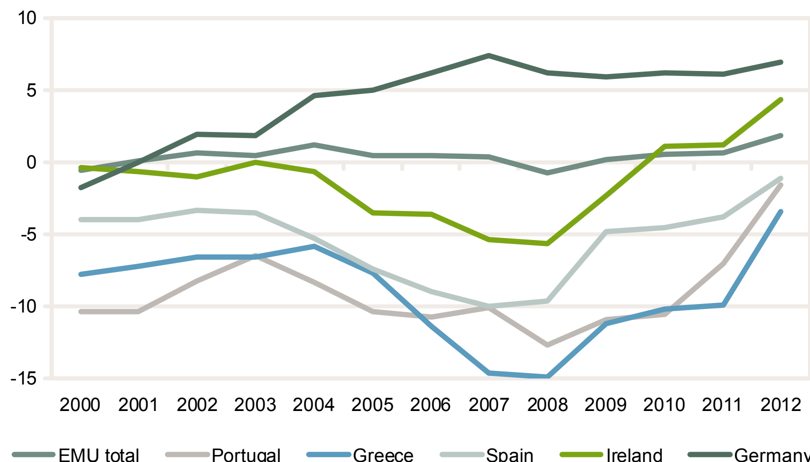
Figure 1: Global current account balances (in USD billion, nominal)



Source: IMF, own calculation.

Note: this paper represents the author's opinions and does not necessarily reflect the views of KfW.

Figure 2: EMU: Current account balance / GDP (as percentage)



Source: IMF, own calculation.

For the group of countries that make up the European Monetary Union (EMU), the current account balance was generally inconspicuous prior to the Eurozone debt crisis. As shown by Figure 2, the balance for the EMU fluctuates between a slight deficit and a slight surplus. However, this conceals substantial differences between the individual EMU member states. Germany in particular as the biggest economy in the EMU with a high surplus stands in stark contrast to the peripheral countries Portugal, Greece, Italy and Ireland with a sharply increasing deficit. Within the EMU, the current account balance / GDP indicator in 2010 ranged from +8.2 % (Luxembourg) to -10.6 % (Portugal).

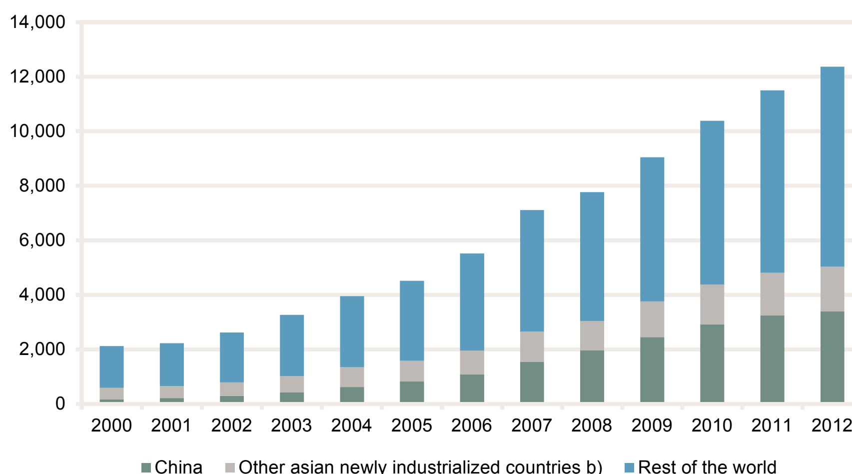
Economic history provides many other examples where current account imbalances have resulted in macroeconomic crises: for instance the 1997/98 Asian crisis, the 1994/95 Mexican "Tequila" crisis or the Russia crisis of 1998.[4] A current account imbalance (especially a deficit) has thus become an acknowledged indicator of undesirable macroeconomic developments and, in the case of deficits, a recognised indicator of crisis. In order to comprehend this and work out solutions, it is necessary to examine real relationships. Below this will be done for the countries that have been the focus of attention since the beginning of the 2000s. In global terms, there can only be surplus countries when deficit countries also exist. Push and pull factors, which lie behind flows of goods and financial flows, are ultimately always two sides of the same coin.

Background to the imbalances in surplus countries

The high current account surplus of **China** is closely related to exchange rate policy and the resultant increase in forex reserves. In global terms, forex reserves have risen enormously since 2000, principally generated by China and other Asian emerging economies (see Figure 3). At present, China alone holds 27 % of the world's forex reserves (USD 3,500 billion). This development began with the Asian crisis. In 1997/98, Asian emerging economies experienced setbacks including serious devaluation. Low forex reserves meant they were unable to defend their currencies.[5] Faced with these difficulties, the countries affected by the crisis had to turn to the IMF, which imposed an austerity programme on them. This not only proved to be unpopular, but also controversial in economic policy terms. After the crisis countries had found their feet again economically, they systematically increased their forex reserves in order to gain greater independence from the unpopular IMF. This was accomplished by means of currency market interventions: the central banks skimmed off part of the net inflow of foreign currency from export transactions and did not make them available for imports. This policy led to an undervaluation of the currencies, particularly so in China[6]. The rest of the world, primarily the USA, criticised the Chinese strategy vociferously, characterising it as a beggar my neighbour policy.

Such an exchange rate policy is closely related to a current account surplus since it stimulates exports and dampens imports. However, it also results in a misallocation of production factors and a distortion of the economic structure. In China, the substantial undervaluation of the renminbi over a long period prompted an excessive expansion of the export economy and led to production sectors manufacturing substitutes for imports that would not be competitive without the exchange rate misalignments. Chinese export subsidies and curbs on import are another issue. China's trading partners complain of protectionism, which is achieved through customs duties (China is a member of the WTO) but chiefly accomplished by means of non-tariff trade barriers and the promotion of

Figure 3: Global forex reserves[a)] (USD billion)



[a)] Foreign currencies, gold, special drawing rights, reserve position at the IMF.
[b)] Hong Kong, India, Indonesia, Korea, Malaysia, Singapore, Thailand.

Source: World Bank, own calculation.

the country's own companies.[7] This protectionism does not, however, automatically lead to current account surpluses. Rather, it primarily distorts the structure of imports and exports, while the balance of trade may be in equilibrium.

The exchange rate, which is controlled by the central bank, is therefore the focus of discussion about the Chinese current account surpluses. Capital exports affected by the central bank and invested in particular in the USA are the counterpart to the surpluses.

This perspective is not shared by all experts. An alternative theory is put forward particularly in the USA, with one of its chief proponents being the former Federal Reserve chairman Mr. Bernanke. This argues that there is a "global saving glut" in China and other surplus countries and that this is the real cause of the high level of capital transfer (mainly to the USA). According to this theory, the Chinese economy as a whole has a very high savings ratio (S) of about 50 % of GDP that exceeds the investment ratio (I). On the one hand, this theory is supported by the fact that the high prices of imported goods (as a result of the undervaluation of the renminbi) have suppressed consumption. On the other, the situation of many Chinese compels them to save more than they actually want to.[8] S>I is however also the inevitable result of the national accounts when a country has a current account surplus.

Much controversy surrounds the high **German current account surplus**. Many researchers point to the relatively moderate wage development that gave Germany a price advantage in the EMU in the 2000s and led to high export growth. Wage stagnation meant low purchasing power and domestic demand, which also slowed down the pace of imports. Moreover, both politicians and the parties to collective agreements are responsible for this wage trend. Wage restraint was therefore also a consequence of Germany's Agenda 2010 labour market reforms. Stagnating private consumption can further be explained by the VAT hike from 16 to 19 % in 2007, and the fact that a general statutory minimum wage has not yet been introduced. The politicians are also ultimately responsible for weak government demand in Germany.

Critics of this school of thought argue that a completely different picture emerges when one examines not only the past decade in Germany, but also the period from 1990. In the 1990s, German unification caused an economic shock. Unemployment rose substantially in the new federal states. This was caused by the currency conversion at a questionable rate, the rapid adoption of the West German social security system and excessive pay increases. Combined with the already existing disincentives in the social security system, this led to low economic growth and high structural unemployment throughout Germany. It proved impossible to reduce the latter even in relatively good years for the economy. Rather, structural unemployment increased continuously. The wage restraint implemented in the early 2000s and Agenda 2010 could have rectified the undesirable developments and the overvaluation of the deutschmark at the beginning of the currency union and provided scope for an economic upturn. However, weak domestic demand is also recognised even by adherents of this school of thought as the reason for the high current account surpluses in Germany. In actual fact, since around 2000 investments (by the public and private sector) have fallen significantly as a ratio of GDP, as did consumption until the start of the global financial crisis. This weakened demand for imports.

In **Japan** the current account surplus before 2008 was principally a consequence of high income from extensive foreign direct investment (FDI) as well as portfolio investment abroad (surplus in the primary income balance). Moreover, wage deflation meant that Japan experienced the smallest increase in unit labour costs within the OECD, and from 2004 the yen depreciated significantly in real terms. This led to a surplus in the balance of trade as well, although a smaller one than in China or Germany.

Oil exporting countries **are surplus countries of a** special kind. As mentioned above, Saudi Arabia is one of the major surplus countries. Other oil exporting countries have, in absolute terms, smaller, but nonetheless enormous current account surpluses as a ratio of GDP (Brunei 47 %, Libya 39 %, Kuwait 37 % and Saudi Arabia nonetheless a very high 24 %, each the 2004–2008 average). Thanks to the global economic boom that ended in 2008, the oil exporting countries benefited from an increase in the volume extracted and exported as well as from a sharp rise in the oil price (from USD 18 / barrel in 1999 to USD 97 in 2008). As these countries have a very small domestic market, they were unable to absorb the considerable increase in income, meaning that current account surpluses and capital exports were inevitable.

It would therefore appear that the current account surpluses may be attributed to a variety of factors in each case. But the surplus countries have something in common: the problems they face are far less pressing than those of the deficit countries. Deficit countries are confronted with the threat of solvency crises and liquidity crises. Surplus countries are not subject to such existential worries. Nonetheless, there are two reasons why they should not just shrug this issue off. First, a surplus country is of course affected when a debtor defaults in a deficit country. Secondly, as set out above surpluses may be associated with adverse developments in the surplus country's own national economy and, in its own interest, that country should correct those surpluses.

Background to the imbalances in deficit countries

Any assessment of the **USA's** current account deficit initially requires an examination of its special role in the global economy. The US dollar is the most important international trading and reserve currency. One reason it has gained this status is that it is available in sufficient quantities. For the rest of the world the US current account deficits, which have existed for decades, were therefore not only acceptable over a long period, but even highly welcome, because it was only in this way that enough dollars were introduced into international circulation for the enormous increase in global trade to be achieved.

This changed in the late 1990s/early 2000s, which saw the end of until then very high economic growth. The US current account deficit increased substantially from USD 140 billion in 1997 (1.6 % of GDP) to USD 800 billion in 2006 (5.8 % of GDP). At the same time, the balance in the state budget reversed: a surplus between 1998 and 2000 turned into a rapidly rising deficit of up to USD 1,860 billion in 2009 (13 % of GDP). In response to the weak economic situation, the Fed switched to a long-term expansionary monetary policy in the early 2000s. This and the above-mentioned increasing capital inflow from emerging economies resulted in a massive lowering of interest rates in the USA (see Figure 4). On the one hand, the combination of low interest rates and liquidity expansion helped the state finance its budget deficit. On the other hand, this also fuelled private consumption. The property boom was particularly noticeable: there was (uncritical) confidence in continually rising property prices and low interest rates over the long term, along with considerable weaknesses in financial market supervision combined with doubtful financing mechanisms on the part of the banks (subprime mortgages, perversion of the securitisation concept). This stimulated demand for property and resulted in a price bubble. When the Fed tightened the monetary reins in an attempt to combat inflationary risks, interest rates rose and the mood changed. The property bubble burst in 2007, triggering the global financial crisis. The massive inflows of capital, which are the mirror image of the US current account deficits, made a decisive contribution to these developments, especially since the (in any case low) US domestic savings declined even further.

It is noteworthy that in the years following 2007 too the USA had a current account deficit of about USD 450 billion per year. Although the global financial crisis had its origins in the USA and the negative developments there entered into the general consciousness, the rest of the world remains willing to undertake such high transfers of funds to the USA. Despite all the anguish, the USA clearly continues to be regarded as a safe haven for financial investments, with high dollar-denominated components of investor portfolios guaranteeing liquidity.

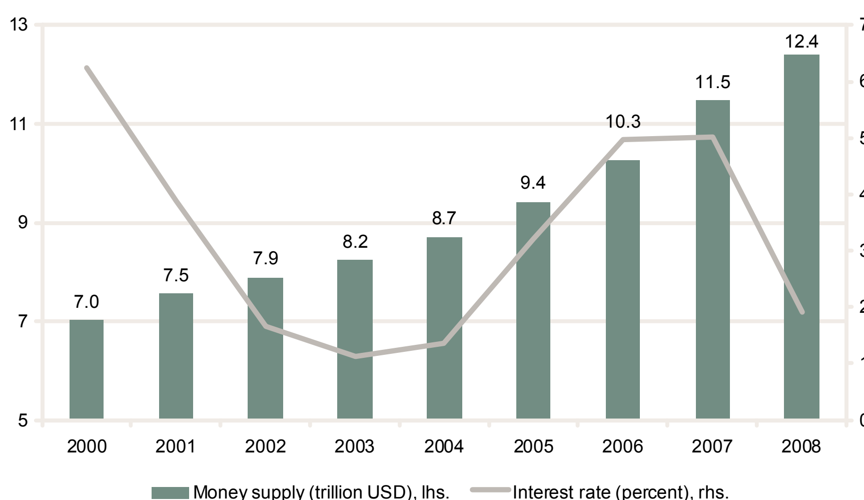
In the **peripheral countries of the EMU** Greece, Ireland, Portugal and Spain, there were different backdrops to the increasing current account deficits in the years preceding the crisis. Excessive private consumption can be determined in all four countries, made possible by strong wage growth that rose far faster than productivity. This undermined international competitiveness. Moreover, a property bubble developed in Ireland and Spain, and there was high public debt in Greece and Portugal. It also goes without saying for the EMU peripheral countries that these developments were only able to have an impact because other countries were ready to finance the rising current account deficits. A variety of factors came together here. First, in the case of a monetary union the possibility of national balance of payments crises may well have been largely ruled out, while investors allowed themselves to be blinded by the completely secure position of the overall EMU current account. Moreover, banks the world over displayed inadequate risk awareness and even granted loans on very favourable terms to borrowers with low credit ratings. They were seduced by the rating agencies and EMU authorities. Rating agencies provided good ratings even for countries with clearly negative developments. In cases of excessive public debt, the EMU authorities made no attempt to apply the sanctions provided for in the Stability and Growth Pact. This led investors to assume that a defaulting debtor nation would receive assistance from other Eurozone countries if the worst came to the worst.

Of the 66 poorer **developing countries** (*low income and lower middle income countries*) examined, 52 had a current account deficit in the reference year 2008, and in half of these countries that deficit was even very high (>10 % of GDP). Poorer developing countries depend especially on volatile food and commodity prices as well as the weather (agriculture), the savings ratio is very low in many countries and the financial sector has barely developed, with limited public budgets and poor general economic conditions impeding development. Current account deficits are more common in these states than in other groups of countries due to the great effect of external factors that cannot be influenced. Excessive government spending also plays a role in many of them. Finally, the deficits are also a sign of the endeavours of countries with less capital to accelerate economic development by means of net capital imports. This aspect will be examined in greater detail in the following section.

A current account imbalance may very well be a good thing

The fact that high deficits are associated with crises is shown not only by the European peripheral countries, but also

Figure 4: USA: Money supply[a] and interest rates[b]



[a] Money supply in the classification M 2 (cash, demand deposits, time deposits up to two years).
[b] Federal Funds Effective Rate.

Source: World Bank, Fed.

by far poorer developing countries, which experienced a massive debt crisis from the 1970s to the 1990s and only regained prospects of development thanks to extensive debt relief. Nonetheless, a current account deficit by no means automatically heralds a crisis but may very well promote development. In developing countries, capital is a production factor that is in exceptionally short supply, meaning the return on investment is potentially high.

But in this respect the actual circumstances in developing countries scarcely merit good grades. Capital imports must trigger a surge in growth that raises domestic production to a persistently higher level. The debt can then be serviced in subsequent years without any loss of prosperity and the country may even live for longer with a current account deficit, since the high growth momentum means that creditors are willing to grant the country further loans. Precisely then, the poor countries stricken by the abovementioned debt crisis faced an enormous problem: their growth was too low and the creditors had no confidence that this would change.

As set out above, the capital imports to developing countries were often not used for investment, but to fund private and public consumption. When a country receives FDI, close attention must be paid. Not every such investment increases the aggregated investments. If it is only a question of takeovers *(mergers and acquisitions*), the income received by the former owners may not be invested but consumed. This holds true in particular for portfolio investments. By contrast, greenfield FDI definitely boost investment. The growth effect of FDI depends partly on the general economic policy conditions. These conditions have indeed improved in poorer developing countries, but the reform agenda remains very long. Finally, it should be remembered that the debts must be serviced in a convertible currency. Because the currencies of developing currencies generally depreciate, this burden increases. To cope with this, the contribution made to growth by FDI must be even greater. In summary, no generally valid boundary between "good" and "problematic" current account deficits exists. However, the respective risk increases the larger the deficit is and the more weakly the economy grows.

Even so, the direction of flow for most poor developing countries meets expectations: capital moves from capital-rich advanced economies to the developing countries ("downhill"). However, as stated, the opposite direction of flow also exists ("uphill flows"). The nations exporting capital include China and the oil exporting countries, but in the years prior to the global financial crisis also e. g. Brazil, Thailand and Malaysia. The frequent use of such terms as "up-and-coming emerging markets" should not hide the fact that China and other emerging markets are still a considerable distance from the advanced economies in terms of development. Thus China, for example, has now managed to become the world's second biggest economy, but its per capita income is a mere USD 5,680 (2012), by comparison with USD 50,120 in the USA. The further expansion of their domestic capital stock therefore also remains important for emerging markets.[9]

Some capital exports from emerging markets and advanced economies are also justified by the demography argument. It is true that Germany, Japan and China are already on the way to becoming ageing societies. Over the medium and long term, these countries are facing a decline in potential growth and per capita growth because the working population is shrinking. Careful consideration should be paid to whether building up capital stock abroad in order to finance future pensions is the right answer to this. More effective alternatives might be to increase the participation in employment, make investments in education and adopt measures to accelerate technical progress, as well as immigration.

The correction of imbalances should not just be left to market forces

The reasons for surpluses and deficits that have been discussed already make it clear that imbalances are not inevitable and that the market mechanism may very well bring about a correction, principally by way of changes in the exchange rate, inflation rates and interest rates. With the free play of forces, a current account surplus results in a currency appreciation that tends to lower exports and revive imports while reducing the surplus. Analogously, the reverse is the case in the deficit country. Additionally, investors from the surplus country assess the situation in the deficit country increasingly critically when there is a high deficit and are accordingly decreasingly willing to finance the deficit or will only do so at far higher interest rates. If an overheating of consumption leads to bottlenecks and inflation, the relative prices also finally move, with repercussions on supply and demand.

As demonstrated, this theoretical ideal did not, however, correspond to reality ahead of the most recent crises. For a long time now, China has manipulated its exchange rate to decisively circumvent the market mechanism. Interest rates and capital markets were highly regulated. Due to the global dominance of the US dollar, there is and has been too little competition in the market for international financial investments. The twin deficits that exist in many countries mean that an important market player, the state, paid too little attention to market signals when organising its market activities. Rather, it placed its trust in the fact that there would be no challenge to its creditworthiness. An additional key factor in the EMU is that, from the viewpoint of an individual member state, the exchange rate is not available as a correction mechanism. This led to an illusion of growth. The Eurozone crisis countries experienced at first hand the bursting of this bubble as a result of excessive abrupt corrections, which not only punished those who behaved "incorrectly" (the state, property sector, inflated wages), but also affected healthy companies and banks, as well as other EMU member states. Other countries with their own currencies were subject to exaggerated reactions and panic-like changes in their exchange rates for which, essentially, there is no justification. Adjustments of this kind are not only corrective, but destructive too, they come too late and result in excessive economic costs. 2009 demonstrates this with impressive clarity: while it is true that the global imbalances decreased substantially (see Figure 1), the world was plunged into the deepest recession since the global economic crisis of the 1920s.

The resurgence of global imbalances since 2009 that can be observed (see Figure 1) could tempt one to conclude that the adjustment was clearly only of brief duration and that there was a resurgence of the problems encountered earlier. However, this is not the case and the phenomenon requires closer examination. The detailed analysis makes clear the effect of both cyclical economic factors and structural reforms. The current account deficit in the USA is far lower than prior to 2009, the EMU crisis countries are undergoing far-reaching reforms and are on the road to balanced current accounts, while Japan's surplus is falling as a result of a high level of energy raw material imports following the decommissioning of its nuclear power plants. China has repeatedly allowed its currency to appreciate, the increase in forex reserves has slowed down considerably and the current account surplus is shrinking. The renewed growth in global imbalances is attributable in particular to the rising deficits of some emerging market countries (India, Indonesia, South Africa etc.), and also to persistently high, or even increasing surpluses, in Germany and other advanced economies.

In summary, the crises experienced in recent times would certainly have been smaller if market forces had come into play, but this in itself is not enough. Economic policy corrections are also required to reduce and preventatively restrict imbalances.

Economic policy correction of imbalances

In the **surplus countries** a strengthening of domestic demand achieved through an induced revival of imports can lead to a more balanced current account. Economic policy can help bring this about by, for example, adopting taxation and social policy that alters the distribution of income in favour of earned income. Promoting the service sector would also facilitate the transition from the production of tradable to non-tradable goods (the tools being the establishment and taxation of service enterprises). Fiscal policy is an area that requires particular sensitivity. Fiscal consolidation is also an objective in many countries with current account surpluses. However, it dampens overall demand in the short term. This is why e. g. the IMF, which was previously a hardliner in this respect, warns those countries able to do so (such as Germany) to take a prudent approach towards consolidation. In the case of China, the economic policy corrections include turning away from an interventionist exchange rate policy. As mentioned above, this is already under way.

An especially heated debate surrounds **Germany's** current account surplus. Working towards cutting exports as a means of reducing the German surplus would be questionable. High levels of German exports are a sign of competitiveness and productivity. Germany should rather reverse the problematic trend towards declining investments and do so not only from the perspective of the current account. The main priority is to boost public investment in order to prevent the state's capital stock from declining further. By improving the framework conditions, the state could and should also support corporate investment (attractiveness of location). Finally, together with the creation of a large number of new jobs, certain recent wage increases may well stimulate private consumption in Germany. All of this would also boost demand for imports. In any case, Germany's relative cost benefit within the Eurozone is contracting, due to both the drastic structural reforms that are cutting costs and the declining wages in the EMU crisis countries.

Financial sector reforms are crucial in both **surplus and deficit countries**. The goals are a strengthening of supervision, regulation and deposit protection, as well as clear regulations on the restructuring or winding-up of banks (to prevent moral hazard). These issues are mainly discussed in connection with the debt crisis in the Eurozone, but are also related to the global imbalances. In both groups of countries, the portfolio investments also deserve greater attention from policy makers. These flows are volatile and frequently susceptible to sentiment, and they can accept a considerable volume.[10]

Many **deficit countries** have twin deficits. Their budgetary consolidation is therefore a key issue. The state can make decisive contributions to strengthening the export sectors and international competitiveness. Deserving of mention here are: turning away from overvalued exchange rates, reducing restrictions on trade, improving the economic infrastructure, investing in education and making general progress in the sphere of governance. A strengthening of the financial sector and promotion of private saving (e. g. by way of more monetary stability) may also reduce reliance upon capital imports to finance investment. A conservative wage policy or even a lowering of nominal wages would also be desirable in many deficit countries. While this primarily falls within the remit of the parties to collective agreements, as a major employer and shaper of the labour market, the state also plays an important role here.

This is a bitter pill for deficit countries to swallow and prescribing it is both a politically sensitive matter and economically contentious, since e. g. debt sustainability is compromised in the almost inevitable adjustment recession. Nevertheless, this medicine is simply unavoidable if serious persistent adverse developments are to be corrected. The effectiveness of this strategy is demonstrated by the recent improvement in the economic position of many Eurozone peripheral countries that have expected their populations to accept budget cuts, dismissals and falling wages in times of great economic crisis. Those countries are now gradually beginning to reap the rewards that result from these painful measures.

In the **EMU** the economic policy correction of current account imbalances is, as mentioned above, difficult, since the individual member countries do not have their own currencies and cannot implement autonomous monetary policies. This means that important market correction mechanisms for imbalances can only be applied in the EMU to a limited extent. Moreover, the recent past has revealed the problems that arise from a combination of unified monetary policy and the non-integration of other areas of policy, in particular fiscal policy. These problems were perceived when the EMU regulatory framework was defined. However, the relevant disciplinary measures provided for in the Stability and Growth

Pact were regarded as adequate. In response to the crisis, the EU has now introduced a new economic policy management element in the form of the "Macroeconomic Imbalance Procedure" (MIP). One of the ten indicators is the current account balance: the warning signal is defined as the interval -4 % / +6 % being exceeded (as a ratio of GDP as a sliding three-year average). Beyond these values, the EU Commission examines and assesses the situation. If the Commission and the ECOFIN Council determine an "excessive imbalance" and the member state does not submit a convincing corrective action plan, a financial sanction may be imposed. It remains to be seen whether this instrument will be applied. In November 2013 the EU Commission announced an analysis of Germany's current account surplus. However, this was not to lead to a sanction, as the EU Commission explained in 2011 on introducing the MIP. Unlike in the case of a deficit, in that of an excessive surplus there would be no question of a sanction because an excessive surplus is allegedly no threat to the smooth functioning of the EMU.

Conclusion

A country that improves its general economic policy conditions and thus boosts exports is not pilloried, unless the relevant tools are used deliberately at the expense of other countries. Equally, current account deficits and debt abroad may not pose a problem, and may indeed make sense if and to the extent that they are used to encourage growth. However, the painful experience of recent years has shown that these conditions are not met in many cases. The conclusion must therefore be drawn that external economic imbalances should not be demonised per se, but that it is necessary to be more alert to negative developments and correct them at an earlier stage, so that in future too the greatest possible benefit can be gained from cross-border trade and financial flows. ■

---

[1] The current account consists of the balance of trade (exchange of goods), the balance of services, the balance of primary income (e. g. interest) and the balance of secondary income (e. g. remittances).

[2] The above-mentioned figures are based on IMF statistics. As virtually all the world's nations are members of the IMF, the global current account should really have a zero balance. The actual divergence between surpluses and deficits thus casts doubt on the correctness of the data. The IMF attributes this phenomenon mainly to the following factors: (i) the unreliability of the statistical collection systems, particularly in developing countries; (ii) differences in assessment in the exporting and importing country (exchange rates etc.); (iii) long transport routes leading to a flow of goods from the exporting country being recorded in one year, but not until the following year in the importing country; (iv) some transfers of income are deliberately reported incorrectly (e. g. for tax avoidance in the case of tax havens).

[3] The groups of nations classified by the World Bank as low income countries and lower middle income countries are defined as poorer developing countries, that is countries with a per capita income of up to USD 4,085. Between these countries and the advanced economies (high income countries) can be found the upper middle income countries, including emerging market countries such as China, India, Brazil etc., whose current account balance situation is different from that of the poorer developing countries.

[4] Officially, the Russian current account during this period was largely balanced. However, the Russian balance of payments statistics are barely meaningful due the massive flight of capital.

[5] There is not the space here to set out the many causes of the Asian crisis. So it must suffice to say that the collapse of the currencies was triggered by a variety of negative developments that included a questionable exchange rate policy. In the months before the onset of the crisis, there were interventions in the currency market that stabilised the exchange rate against the US dollar, which brought about a generally increasing overvaluation of the respective currencies. A devaluation was therefore inevitable, although a larger buffer of forex reserves would have made possible a certain cushioning and longer time scale for this adjustment.

[6] China has pursued this exchange rate policy even though it was not one of the Asian crisis countries. But the Chinese leadership had observed very precisely the consequences of being vulnerable due to low forex reserves. Building up high forex reserves was also a way for China to underpin its claim to be a global player.

[7] The organisation Global Trade Alert, an independent monitoring service for commercial policy, classifies China as a country with strong restrictions on trade. However, China is regarded not only as a "perpetrator", but also a "victim" of other countries' protectionism.

[8] Thus far only very few Chinese are able to take out insurance against such basic risks of life as illness, age and unemployment, but they are forced to make provisions for these risks by consuming less and building up savings.

[9] The direction of capital flow normally expected is, however, not just a result of the world being divided into "rich" and "poor" countries, but is also based on the assumption that capital productivity is higher in the poor countries. However, this is not automatically so. Despite a low capital stock, the capital productivity of a poor country may be low, e. g. due to bad economic policy. It is up to the country itself to ensure the "right" direction of flow by improving the general conditions.

[10] KfW Economic Research will soon deal with this topic in a separate paper.