

## **Comments on Otmar Issing's “Addressing Global Imbalances: The Role for Macroeconomic Policy”**

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**Banque de France International Symposium on  
“Productivity, Competitiveness and Globalization”  
November 4, 2005**

Pliny the Elder is well known for his quote: “In these matters the only certainty is that nothing is certain.” I doubt that Pliny was concerned with global imbalances during the 1<sup>st</sup> century A.D.—but his phrase accurately captures the current discussion on this subject. Despite numerous academic papers, policy debates and entire conferences dedicated to the topic of global imbalances, there is still widespread disagreement on its primary causes and likely evolution. Otmar Issing's paper does an excellent job of covering the key points of this complex and multifaceted issue, and especially of incorporating the latest views on this topic.

I will begin my comments with a very brief summary of Issing's paper. Then I will make four main points: what I see as the most important conclusion from the paper; how to integrate the apparently divergent explanations of global imbalances; why additional estimates of the impact of different actions on global imbalances is important; and what are additional policy responses to resolve global imbalances that aren't discussed in the paper.

Issing's paper starts by succinctly summarizing recent trends driving global imbalances. It then discusses, in more detail, the role of different macroeconomic policies in causing these imbalances and potentially resolving them in the future. More specifically, the paper focuses on the role of saving-investment imbalances, productivity growth, fiscal policy, global savings glut, interventions in foreign exchange markets, exchange rate policies, and structural reforms. It concludes that fundamental imbalances in private savings rates around the world are a key cause of global imbalances, although other factors have also played a material role. The paper ends with a short discussion of the likely adjustment process, stating that these imbalances “need to be addressed through decisive policy action”, because the longer they continue to accumulate, “the higher the risk of an abrupt adjustment and the larger the adjustment costs will be for the global economy.”

My first point is what I see as the most important conclusion from the paper. Issing writes: “Clearly, the threat of global imbalances concerns every single actor in the global economy, and thus all parties involved need to contribute their part to a resolution.” [Underline added] The current global imbalances are caused by a number of factors linking each major region of the world. Governments in each region need to take responsibility for their role and take action. It is much easier for governments to blame other economies for the current imbalances and to pressure other governments to take action—whilst not assuming responsibility oneself. It is even possible for each major government to rationalize this approach by focusing on the causes of the global imbalances that occur outside their borders. This “finger-pointing” approach, however, will not foster an environment in which individual countries will take the necessary steps to reduce global imbalances.

Despite making this key point, Issing's analysis slips into what might be called a new form of "home-country bias". The paper dedicates 5 ½ pages to saving and investment issues in the United States, but only 1 ½ pages to the "global savings glut" (i.e. saving and investment issues in the rest of the world). Similarly, Issing only dedicates 1 page to the role of Europe—mainly to argue that structural reforms in Europe would have little effect in reducing global imbalances, and therefore implying that Europe has a minimal role to play in any adjustment. This strategy of suggesting that policy actions need to be taken by other countries directly contradicts the key point that Issing highlights in other sections of his paper—that all major regions of the world need to take responsibility and action.

My second major point is that the apparently diverse explanations for global imbalances are not necessarily inconsistent, and that linking these theories into one coherent framework can have useful insights for any adjustment process. Issing writes: "...few agree on what precisely constitutes these imbalances." He also discusses how global imbalances have both a real and financial side. Extending this framework, standard balance-of-payments accounting yields the following identity that holds for each country:

$$\text{Current Account} = - \text{Capital Account} + \Delta \text{Reserves} = \text{Saving} - \text{Investment}$$

Different explanations for global imbalances focus on one part of the equation. For example, some policymakers focus on factors causing a large U.S. current account deficit (such as strong U.S. GDP growth), while others focus on factors causing the large U.S. capital account surplus (such as strong U.S. productivity growth) or on causes of the saving-investment imbalance (such as the large U.S. budget deficit). Although these discussions may sound as if they are focusing on vastly different causes—they are all interrelated. Any adjustment in one part of the equation must be balanced by adjustments on the other sides of the equation.

This framework is particularly useful when evaluating different proposals to reduce global imbalances. Working through how a policy proposal that appears directed at one part of the equation would in turn affect other sides will quickly accentuate how any adjustment must be multifaceted and involve more than one region of the world. For example, if the United States followed the popular advice to raise aggregate saving (through either a reduction in the budget deficit and/or an increase in private saving), this would have to be balanced by a smaller current account deficit and smaller capital account surplus. The reduction in the current account deficit would most likely occur through lower exports from other countries to the United States. Higher aggregate saving would also likely lead to lower interest rates, so that other countries would reduce purchases of U.S. assets. Therefore, even a policy adjustment focused on the United States would have important ramifications for global trade and capital flows.

My third point is on the estimates of how different policy actions would affect global imbalances. Issing does an excellent job compiling estimates from a range of studies done over the past 20 years of how an improvement in the U.S. fiscal position would affect the U.S. current account deficit. This is the best table—by far—that I have seen of this empirical evidence. Issing summarizes this evidence as showing that a 1 percent improvement in the

U.S. budget balance would reduce the U.S. current account deficit by somewhere between 0.3 percent and 0 percent.

After this very detailed analysis of how a reduction in the U.S. budget deficit would affect the U.S. current account deficit, Issing provides little discussion of the magnitude of how other policy adjustments would affect global imbalances. Granted, many other policies have not been analyzed in nearly as much detail, but several recent studies provide useful estimates. For example, IMF (2005) estimates that a ½ percent a year increase in real GDP growth in Japan or the large Euro-zone countries would reduce the U.S. current account deficit by about 0.2 percent of GDP after three years. Cline (2005) estimates that 1 percent faster foreign growth for one year would reduce the U.S. current account deficit by 0.4 percent of GDP in three years. Interindustry Economic Research (2005) estimates that a 25 percent depreciation of the dollar against all Asian currencies would reduce the U.S. current account deficit by 0.5 percent of GDP in five years. The same study estimates that a 25 percent depreciation of the dollar against all currencies would reduce the U.S. current account deficit by 1.6% of GDP in the same period.

The U.S. current account deficit does not need to shrink to zero in equilibrium, and most analysts estimate that the U.S. current account deficit would need to fall to about 2% to 3% of GDP in order to stabilize U.S. external debt ratios.<sup>1</sup> The empirical results discussed above clearly suggest that no single policy would be able to reduce the U.S. current account deficit to this sustainable level. Therefore, as Issing clearly states in the paper: "...it is a set of policies or policy 'package' that needs to be applied..." Including empirical estimates of how policies in addition to reducing the U.S. fiscal deficit will affect global imbalances accentuates this key point. It also confirms the key point discussed above—of the need for concerted responses from all regions in the world to smoothly reduce global imbalances.

My final point is that it would be useful to expand on the typical prescriptions to reduce global imbalances discussed by the G7, the IMF, and in Issing's paper to include additional alternatives. For example, Rodrigo Rato, the Managing Director of the IMF, stated the typical view: "The measures needed are well-known, but bear repeating. They are: medium-term fiscal consolidation in the United States; structural reform in Europe and Japan to raise economic growth and turn their economies into additional centers of global expansion; and greater exchange rate flexibility in China and emerging Asia..."<sup>2</sup> As the estimates discussed above indicate, however, substantial (and politically unlikely) adjustments in these three areas would be required in order to reduce global imbalances to a sustainable level. Therefore, it is helpful to think about what other policy options might help reduce imbalances.

One recommendation is to take steps to raise investment in emerging markets. Some analysis has recently indicated that a major factor behind the "global savings glut" is reduced investment in emerging markets (rather than increased saving). Taking steps to improve the investment climate and support investment in emerging markets—such as strengthening corporate governance, simplifying regulations so that it easier to start a business, reducing

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<sup>1</sup> For a discussion of this calculation, see Forbes (2005).

<sup>2</sup> Remarks by Rodrigo de Rato, "Sustaining Global Growth and Stability – The Role of the IMF," at Georgetown University in Washington, D.C. on April 6, 2005.

limitations on foreign investment, and improving infrastructure—could all help raise investment and therefore close the saving-investment gap. The impact of higher investment in emerging markets on global imbalances could be substantial. For example, IMF (2005) reports that increasing the investment to GDP ratio by an additional 5 percent in major emerging markets in East Asia (Indonesia, Korea, Malaysia, the Philippines, and Thailand) would reduce the U.S. current account deficit by about  $\frac{3}{4}$  percent of GDP after three years. Although increasing the investment ratio by 5 percent may sound like a large increase, this would only reverse about one-half of the decline in investment that has occurred in these countries since 1996. Moreover, increasing the investment to GDP ratio by the same 5 percent in oil-producing economies would also reduce the U.S. current account deficit by about  $\frac{3}{4}$  percent of GDP.

A second recommendation for reducing global imbalances is to increase private saving in the United States. Although this is not easy to do, it could make a significant difference. For example, IMF (2005) estimates that a permanent 1 percent of GDP increase in the U.S. gross national savings rate would reduce the U.S. current account deficit by about  $\frac{1}{2}$  percent of GDP after three years. The current discussion of tax reform in the United States provides an excellent opportunity to adjust the tax code to promote private saving.

A final recommendation is to raise domestic consumption in Asia. This is also not easy, but there are a number of concrete steps that governments could take. For example, strengthening social safety nets (especially the provision of health care services, pension systems, and transition assistance for workers who lose their jobs) could all reduce the need for precautionary saving by individuals. Allowing overvalued exchange rates to appreciate would reduce the price of imports, possibly increasing consumption. Liberalizing the financial sector, and especially allowing greater collaboration with foreign institutions that have developed more advanced financial products, could provide individuals with more financial flexibility to support consumption. Although I certainly would not recommend that Asian economies increase consumption to the levels that currently exist in the United States, steps to support domestic consumption would not only help smoothly reduce global imbalances, but perhaps even more important, would support more balanced growth and reduce vulnerabilities to changes in external demand.

To conclude, Herbert Stein (a former chairman of the Council of Economic Advisers) is well known for his famous quote: “If something is unsustainable, it will end.” Slightly less well known is an addendum by the MIT economist, Rudiger Dornbusch. Dornbusch used to warn his students that something unsustainable can last much longer than anyone thinks, but once it ends, it can unravel much faster than anyone expects. If adjustments to global imbalances do not occur soon, there is a good chance that they will unwind much faster than people expect. Therefore, policymakers will hopefully listen to the key themes in Issing’s paper. Now is the time to act, and action should be taken by all major regions in the world. If this does not occur, the unwinding of existing global imbalances may not just occur more quickly than people expect, but the process is more likely to be disorderly and imply greater adjustment costs for the global economy.

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