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Bank of Japan

Global Imbalances and Current Account Imbalances

Remarks at the Banque de France
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Masaaki Shirakawa
Governor of the Bank of Japan

Introduction

Let me first thank Governor Noyer and the Bank of France for giving me the opportunity to contribute to the special issue of the Bank's Financial Stability Review (FSR) on global imbalances and financial stability. It is also a great honor to take part in today's launch event panel.

The theme of the FSR, global imbalances, is a very complex and challenging topic and includes a host of issues. I must confess that I have not read the entire 170 pages of the FSR, but going through some of the articles in the flight to Paris yesterday, I was struck by the diversity of the issues raised in the papers. Each of the contributions by the G20 Central Bank Governors has its own unique angle. This is a reflection of the multi-faceted nature of the topic.

I would like to focus my remarks on the use of the current account balance as an indicator for assessing the sustainability of global imbalances, while reviewing Japan's past experience as well as the lessons we have learned from the current global crisis.

Experiences from Japan's Past and the Current Global Crisis

During the 1980s, Japan's trade and current account surplus expanded sharply, and by the mid-1980s, Japan was receiving strong external pressure to appreciate its currency and reduce its surplus. Through joint intervention, the yen rose sharply after the 1985 Plaza Accord and macroeconomic policy, including monetary policy, was geared toward expanding domestic demand. Although the current account surplus fell by the end of the decade, Japan was saddled with the huge challenge of dealing with the bursting of the bubble. I certainly am not arguing that external pressures and the focus on reducing the current account surplus caused the bubble. But, they did contribute to fostering an environment where it was more difficult for authorities to act promptly when there were signs that the economy may be overheating. Current account figures as such did not provide information on the emergence of unsustainable imbalances which would have implications for economic policy.

This argument could also apply in the current global crisis. Focusing on the widening US current account deficit and the large increase in foreign exchange reserves in emerging markets, in the mid-2000s, concerns were raised that a disorderly adjustment would occur through a sharp fall in the value of the dollar and a jump in long-term US interest rates. However, as we all know, what came to pass was quite different. At the outset of the financial crisis, a global flight-to-quality occurred as market participants became extremely risk averse. U.S. long-term rates fell substantially as demand for US Treasuries increased, and the dollar strengthened against most other currencies.

Then, the question becomes, how can we identify the imbalances which could lead to unsustainable global imbalances? What type of information do we need to focus our attention on? I would like to point out two areas; excess leverage and gross capital flows.

The first area is the build-up of excess leverage in the economy. In both Japan and US, in the run-up to the crisis, we witnessed large deviations from long-term trends in private sector debt. In Japan, it was the corporate sector and in the US the household sector. It is important to have both an economy-wide assessment and assessment at a somewhat more disaggregated level. This would enable policymakers to obtain a better sense of where imbalances may be accumulating. Another element that is important is the mechanisms through which credit is being provided. In both countries, the shadow banking sector played a key role in supporting the credit boom.

The second area is gross capital flows. Information on net capital flows corresponding to current account balances need to be supplemented with other sources of data. A case in point would be recent developments in the euro area. The current account of the euro area has been generally balanced during the past decade. But euro area banks actively intermediated US dollar funds from the international banking system to the non-banking sector in the US. Although the netted amount was small, the accumulation of risks which increased on a gross basis was substantial.

Lessons from the Past

I would like to point out three lessons from current and past experiences, fully recognizing that there may well be others.

First, trends in current account balances are the reflection of longer-term trends in savings and investment which are strongly influenced by the stage of economic development and demographics. Within these trends, surpluses and deficits emerge as a result of the voluntary choices of economic entities and thus should not be automatically deemed as problematic. Current account imbalances will only lead to problems when they become unsustainable.

Second, distinguishing between the structural and cyclical components of the current account balance is often a difficult task. Trying to adjust the structural component through macro-economic policy and exchange rate policy entails the risk of causing the development of destabilizing financial imbalances. A narrow policy focus on current accounts *per se* can be counter-productive.

Third, central banks and other authorities need to assess the possible emergence of unsustainable imbalances using a wide range of indicators such as asset prices, leverage, gross capital flows and information on risk pricing and risk profiles of financial institutions. Current account data only provide us with a partial picture. In the past, when the cross-border flow of goods and services dominated interrelationship among economies, assessing current account and trade balances would give us a relatively good picture of emerging external imbalances. But the size of global capital flows has dramatically increased and the speed with which capital moves to and from one country to another has accelerated as well. The approach for assessing global imbalances needs to change accordingly.

Current Changes to the Environment

After reviewing the lessons from the past, authorities also need to adapt their policies to real time changes in the global financial and economic system. We are currently experiencing some large fundamentals changes and are also in the midst of a recovery phase from a severe economic and financial crisis.

Through further acceleration in globalization, the interlinkages between financial markets and among market participants are becoming increasingly complex. Shocks in one part of the world will swiftly spill over to other parts and often through unexpected channels.

Another fundamental change is the increasing presence of emerging market economies. Emerging economies have become the drivers of global growth, and consequently their responsibilities as members of the global community have increased. For example, it needs to be recognized that the implications of inflexible exchange rates in major emerging economies have become larger. The perspective of an orderly structural adjustment process for domestic industries may warrant a gradual shift from fixed exchange rates to a more flexible exchange rate system and a controlled appreciation of the home currency. But, at the same time, policymakers in emerging economies need to recognize that a policy of very gradual exchange rate adjustment both hampers the flexible implementation of domestic macroeconomic policies, including monetary policy, and exports the cost of the adjustment to other countries. If other countries follow with similar policies, the impact on economies which allow flexible exchange rate movements could be magnified.

A third unique aspect is that we are in the midst of a dual-speed recovery. While emerging economies are continuing their robust growth, recovery in advanced economies is slow, due in part to the balance sheet adjustment process following the bursting of the bubble in some countries. Central banks in advanced economies have implemented extremely accommodative monetary policy. Since monetary easing through the traditional interest rate or credit channel is not working like in normal times, capital is flowing into high growth emerging economies which do not face such constraints.

Challenges for Policymakers

Let me conclude by pointing out an important challenge for policymakers going forward. A key sea change that we are witnessing is that through rapid globalization the identification of harmful imbalances and implementing rebalancing measures can no longer be a purely domestic process. In formulating macroeconomic policy, the traditional emphasis was to ensure domestic stability or to put one’s house in order. However, with the deepening of globalization, the simple sum of each country’s policy action may not necessarily achieve an optimal outcome at the global level. Policymakers in both advanced and emerging economies need to rethink the meaning of domestic stability. It has become ever more important to review the spillover effects of their policies across borders which will also reverberate back to each country through economic and financial interlinkages.

When considering possible financial imbalances stemming from large capital inflows or inflexible exchange rate regimes, there are no easy solutions which would satisfy each and every country's needs both from an economic and political standpoint. But since we are all in the same boat, if we all start rowing in different directions, the risks of a fallacy of composition would increase. There are no mechanical or automatic mechanisms which can guide our economic policies. The complexity of how the current global crisis unfolded across financial markets and economies, as well as the new difficulties that continue to emerge, are reconfirming this point. At the outset, I mentioned the diverse range of perspectives presented in the contributions by the Governors. I believe there also is a common message coming from the central banking community. It is that cooperation among policymakers is indispensable and needs to be further enhanced. For policymakers, humbly learning from each other's experiences and constructive dialogue, though perhaps not fancy solutions, are essential, as our boat continues through uncharted waters.