Box 2.2

Recent situation of global current account imbalances

The large global current account imbalances in the mid-2000s, fuelling protectionist sentiment, were a key source of trade conflicts. Nevertheless, the situation improved notably in recent years, alleviating the threat of protectionism to world trade. Particularly remarkable was the rapid decline of the current account deficit in the US to 2.3% of GDP in 2013 from its peak of 5.7% in 2006, based on data compiled by the International Monetary Fund. The current account balance of the debt-ridden eurozone members taken together saw a turnaround, from severe deficits to a slight surplus in 2013. On the other hand, the current account surplus of Mainland as a percentage of GDP shrank sharply from a high of 10.1% in 2007 to only 2.1% in 2013. Japan's current account surplus has also become much smaller in recent years, while that of oil-exporting countries in the Middle-east and North Africa came off the peak amid more stable oil prices. (***Chart 1***).

The improvement of the world external imbalances proceeded quickly in the aftermath of the global financial tsunami of 2008. Given worsening consumption and investment sentiment amid sharp swings in global asset prices and economic downturn, imports of deficit countries plunged, which outpaced the fall in exports and reduced the current account gaps. At the same time, many surplus countries made use of their policy room to expand domestic demand in the face of flagging external demand, which lent support to their imports and sped up the current account adjustment.

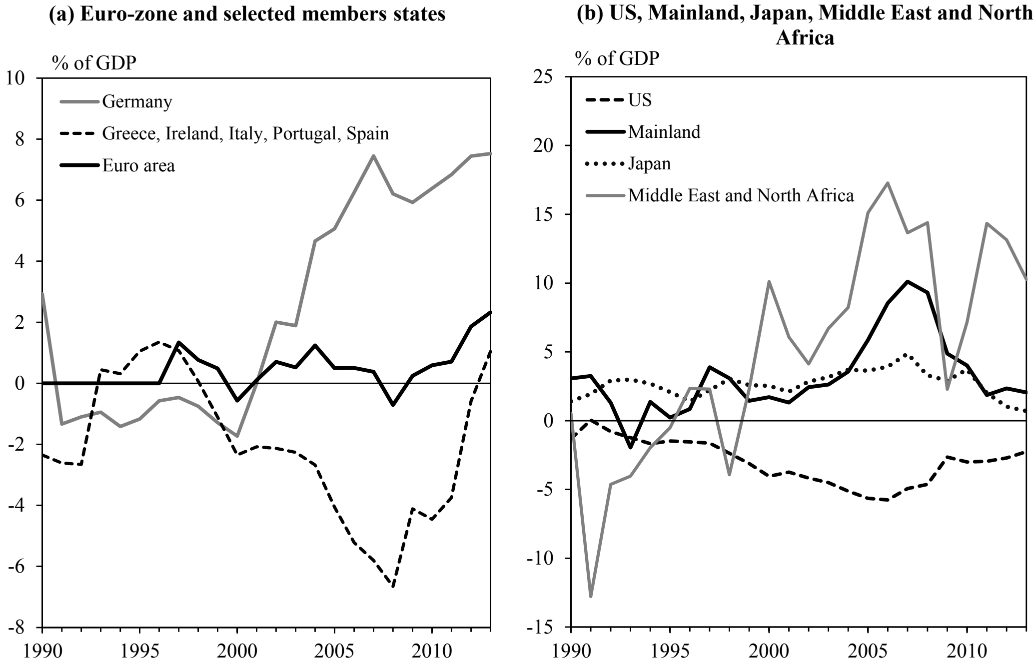
Since the current account balance is a mirror of the difference between national saving and investment, its adjustment also reflected fiscal reforms and other structural changes that altered public and private sector spending patterns. In the US and many deficit countries in the eurozone, private sector deleveraging has made a long stride as households cut back consumption and residential investment in the wake of high unemployment and falling home prices while corporates scaled back capital expenditure amid a subpar recovery environment. The authorities also cut government expenditure and repealed tax concessions to lower budget deficits. The attendant increases in savings and decreases in investment dented import demand and lowered the current account deficits in these countries.

Over this period, the Mainland stepped up reforms to steer the economy towards domestic demand-led growth, as enshrined in the National 12th Five Year Plan. The progress in pension and healthcare reforms in recent years should have also helped encourage households to reduce precautionary savings. The supportive policy mix in the Mainland was conducive to import expansion, driving its current account surplus lower amid weaker export performance. In Japan, the closure of nuclear plants after the devastating earthquake in 2011 has sent the energy imports bill significantly higher, throwing the trade balance into deficit and thereby compressing the current account surplus to a historically low.

The global rebalancing should also have been facilitated to some extent by the real exchange rate adjustments in surplus and deficit countries. Between 2008 and 2012, both the US dollar and the euro experienced real exchange rate depreciations, while the renminbi appreciated notably in real terms since the re-start of exchange rate reform in 2010 and the Japanese yen also came under persistent upward pressure before 2012. These exchange rate trends encouraged deficit countries to cut imports and surplus countries to switch expenditure to local consumption and investment. But these trends were partly reversed since early 2013, as the Fed planned for asset purchase tapering and Japan pursued more aggressive monetary easing.

Box 2.2 (Cont'd)

Chart 1: The global landscape of current account balances



Yet, several emerging market economies have bucked the improving trend of global imbalances. Brazil, India, Indonesia, Turkey and South Africa, for examples, all ran a twin deficit of current account and government budget in 2012 and 2013, with their current account deficits growing and increasingly financed by short-term capital flows, leaving them more vulnerable to capital flow reversals and higher interest rates when the US Fed began to reduce monetary stimulus. Also, the current account surplus of Germany was sizeable as import growth was dragged by a slow domestic demand pick-up, while those of oil exporting countries remained large, leaving scope for further improvement.

Apart from fuelling protectionist sentiment, large global external imbalances were sometimes conceived as a potential source of excessive capital flows across regions. While the recent global financial crisis had more to do with lax supervision and regulation of financial markets in some major economies, reducing global imbalances should be conducive to global financial stability. More importantly, the rebalancing should help mitigate trade friction and lay a stronger foundation for the global trade recovery down the road, to the benefit of export-oriented economies, including those in Asia.

In sum, though with some notable exceptions, the current account imbalances among major economies have narrowed remarkably in recent years. However, the future prospect is still subject to uncertainty. Deficit countries should hammer out longer-term sustainable fiscal plan to cope with rising public spending needs in the face of demographic shifts and follow through structural reforms to lift their external competitiveness. Surplus countries have to deepen supply-side reforms to attain higher productivity gains and expand domestic demand. Emerging market economies with large current account deficits should also take prompt actions to address local vulnerability and get prepared for heightened financial volatility caused by the eventual exit of US Fed from its unconventional monetary policy.