

International adjustment and rebalancing of global demand: where do we stand?

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Despite the appearance of a moderate adjustment, the partial narrowing of global imbalances since the global financial crisis masks considerable changes in the way in which these imbalances are financed and in underlying imbalances in domestic demand.

Capital flows from and to the private sector, which in large part financed current account imbalances before the crisis, have plummeted. This reversal is similar in scope to that experienced by emerging economies during the crises of the past decade. However, the collapse in private flows did not lead to a sharp adjustment in current accounts, as private flows were replaced by flows from and to the public sector.

The partial decrease in current account imbalances was accompanied by a significant drop in the domestic demand of countries with a current account deficit. So far, the adjustment has been asymmetric, with a smaller increase in demand in surplus economies, which has contributed to subdued global growth. The increase in domestic demand in the surplus economies is itself mostly due to the growth differential between these economies (notably China) and deficit economies, and little to the internal rebalancing of their growth models.

Key words: global imbalances, capital flows, asymmetric adjustment

JEL codes: E21, F32, G15

Current account imbalances have been a prominent feature of the international monetary system as well as a recurring theme in economic policy debate since the 2000s. Despite fears of a sharp correction, the imbalances decreased only slightly during the global financial crisis that started in 2007, without leading to strong turmoil on the foreign exchange markets. A case in point: the narrowing of the US current account deficit was accompanied by a rise in the dollar, instead of the sharp depreciation anticipated by many analysts. Since then, global imbalances have remained large. This relative stability nonetheless masks major changes in how imbalances are financed and the geographical distribution of global demand. This paper details these changes.

Firstly, while current account imbalances have narrowed only moderately since the crisis, the private flows that largely financed these pre-crisis imbalances have plummeted. Within the G20 taken as a whole, the sum of current account deficits dropped by 1.5 percent of GDP between 2006 and 2009. Over this period, flows towards the private sector in G20 deficit countries shrank by 4.2 percent of GDP. Flows towards public sectors took over the financing of current account deficits with a 2.7 percent increase in GDP. A similar but stronger development may be observed in changes in the financing of imbalances among euro area countries. These results are consistent with the research on global liquidity, which carefully distinguishes between private and public liquidity, noting that in times of crisis, the latter replaces the former (Committee on the Global Financial System – CGFS, 2011). “Sudden stops” in private flows also contradict the “Lawson doctrine” articulated by the UK’s former Chancellor of the Exchequer, which states that current account deficits that reflect private savings and investment decisions are generally sustainable.

Secondly, the narrowing of current account imbalances was accompanied by a reduction in underlying imbalances in domestic demand. Domestic demand in deficit economies, which had surged with the widening of global imbalances, shrank significantly. So far, this adjustment has been asymmetric, as demand from surplus countries has only partially filled the gap. This has dampened global demand and is a factor in the current context of sluggish growth. Between 2006 and 2012, the domestic demand of G20 countries running a current account deficit decreased by 11 percentage points in share of G20 potential output,¹ while that of countries with a current account surplus increased by only 7 percentage points. The difference – 4 percent of potential output – reflects weak demand across G20 economies and corresponds largely to a deterioration in the G20 output gap. The increase in the share of the demand of surplus economies is itself partly an automatic result of these economies’ greater share in G20 GDP – mainly as a result of China’s strong growth.

1 Using potential GDP estimated in the IMF’s World Economic Outlook.

If this composition effect is disregarded, the increase in surplus economies' domestic demand represents less than one G20 GDP point.

Global imbalances have been widely studied in the literature; we do not detail all the discussions here. Chinn, Eichengreen and Ito (2011), Bussière *et al.* (2010), Obstfeld and Rogoff (2009), Obstfeld (2012) have all presented reviews of the literature. Recently, there has been substantial research on the distinction between public and private flows. A first group of research shows that the distinction between public and private flows is essential to understanding the widening of global imbalances and the associated apparent paradoxes. Pre-crisis, capital flowed from economies with high growth but scarce capital towards economies with low growth and abundant capital, contrary to the prediction of conventional theory (Lucas *Paradox*, 1992, Gourinchas and Jeanne's *Allocation puzzle*, 2013). Alfaro *et al.* (2011) showed that this movement was driven by public capital flows and that private capital, on the other hand, flowed towards developing economies with high productivity growth. A second group of research shows that the distinction is also important when analysing the adjustment of capital flows since the onset of the crisis (Bluedorn *et al.*, 2013), with most of this research being focused on the euro area (Auer, 2013; Merler and Pisani-Ferry, 2012). This paper takes a more general look at trends in the G20 economies. Asymmetric adjustment is a persistent topic in international economics, and was one of the issues at stake in the Bretton-Woods negotiations when the international monetary system was rebuilt after World War II (Bordo, 1993). The onset of the global financial crisis has seen the issue once again attract attention as part of the debate on the reform of the international monetary system (Joshi and Skidelsky, 2010).

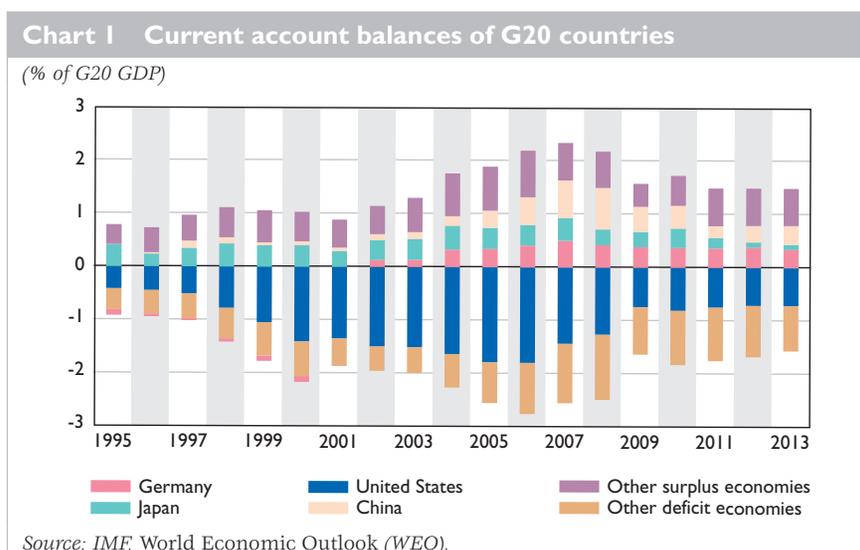
I | International adjustment: plummeting private flows

I | I | A marked widening in current account imbalances before the crisis

The marked widening in current account imbalances was a key feature of the global economy pre-crisis. The United States accounted for between two-thirds and three-quarters of the total deficit of G20 countries. China, Japan and Germany accounted for between half and three-quarters of the total surplus. Oil-exporting countries also accounted for a substantial share of this surplus. These imbalances decreased during the 2009 recession, as did global output and trade, and have since stabilised. The absolute sum of current account imbalances in the G20 countries peaked in 2006 and 2007 at 5 percent of G20 GDP, and has remained near 3 percent of G20 GDP since 2009.

I | 2 Fears of a sharp adjustment...

The unprecedented size of current account imbalances prior to crisis led analysts to fear a sharp adjustment (see for example Roubini and Setser, 2004, 2005). In this scenario, capital flows from surplus economies would have abruptly stopped financing countries in deficit. This sudden drying up of capital would precipitate significant exchange rate swings (Obstfeld and Rogoff, 2007; Blanchard, Giavazzi and Sa, 2005)² and a risk of market instability. The risk however depended on the type of financing considered. The flows, which partly financed the increase in private sector leverage in deficit economies, were particularly risky when they fuelled growth in asset prices and increased the financial fragility of the countries to which they flowed. The emerging market crises at the end of the 1990s showed how such episodes could result in the precipitous drying up of inflows, a large depreciation in the exchange rate, an asset price bust, banking crises and deep recession.³ A significant share of the surpluses however came from the accumulation of foreign currency reserves by the major emerging economy central banks, especially in Asia, which was perhaps driven by a different logic. For Dooley, Folkerts-Landau and Garber (2004) for example, the accumulation of reserves was a consequence of an export-driven development strategy and could continue for a long time. Bacchetta, Benhima and Kalantzis (2013) discuss for example when reserve accumulation is optimal.



² Empirically, external imbalances have high predictive power (see e.g. Della Corte, Sarno and Sestieri, 2012).

³ See for example research on currency crises by Kaminsky and Reinhart (1999), Bussière and Mulder (1999), Berg and Pattillo (1999), etc.

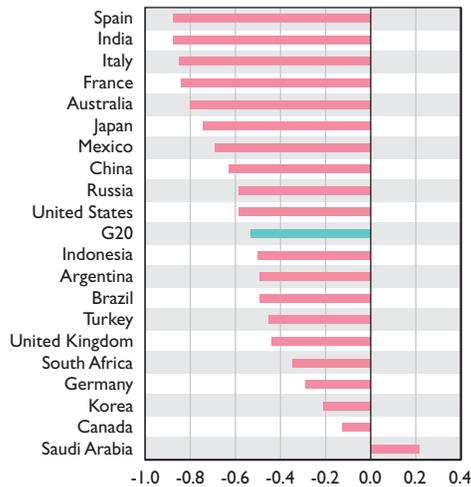
I | 3 ... which did not occur, due to the financing circuit

At first glance, the sharp adjustment that some analysts feared does not appear to have occurred. The US dollar did not depreciate massively, but instead rose at the peak of the crisis. However, looking at the composition of capital flows leads to a different picture: while the reversal in capital flows did indeed occur, it affected only flows from or to the private sector, but not aggregate flows.

Charts 2 Net private and public flows

(% of G20 GDP)

a) Correlation between public and private flows



b) Correlation between public and total flows



Sources: IMF, balance of payments, own calculations.

In this section, we break down the financial account, counterpart of the current account, into net “public” and “private” capital flows.⁴ To do so, we use IMF balance of payments data. “Public” flows are defined as all cross-border financial transactions that involve assets and liabilities of the monetary authorities and government of the economy under consideration. For example, on the liabilities side, the purchase of government debt securities by non-residents is classified as a public flow, irrespective of whether the non-residents are from the private or public sectors. On the assets side, the accumulation of reserves by the central bank, or the granting by the government of an assistance loan to another country are also defined as public flows. Net private flows are defined as the difference between the financial account and net public flows.⁵

Public and private flows behave differently. They are usually negatively correlated, with an average correlation of negative 0.5 for the G20 as a whole (see Chart 2a).⁶ In most emerging economies, net public flows are strongly positively correlated with total flows, while the correlation is weak for most advanced economies (see Chart 2b).

Since the onset of the global financial crisis, there has been a reversal in net private capital flows, partly offset by opposing net public capital flows.

|3| The reversal of private capital flows...

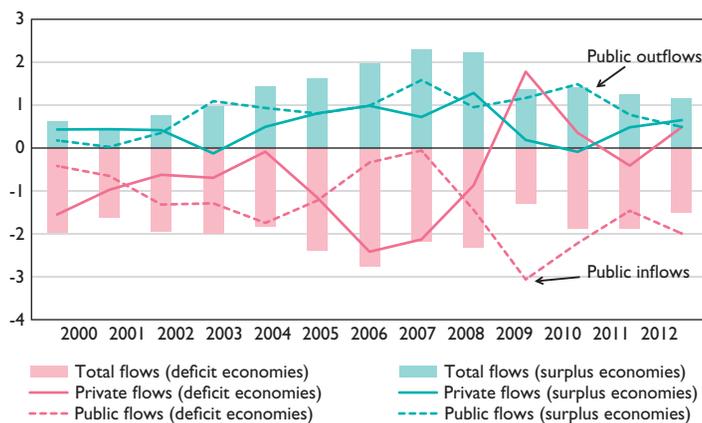
Chart 3 depicts trends in total and private net capital flows for the G20 countries, distinguishing between countries running a current account surplus and those running a deficit. To facilitate the comparison with Chart 1, which shows current account balances, net capital outflows, which correspond to current account surpluses, are depicted by a positive balance on Chart 3 (see Box).

Pre-crisis flows towards private-sector instruments financed a significant share of current account deficits. In 2006, net private flows to deficit economies accounted for 2.4 percent of G20 GDP, compared with 0.3 percent for net public flows. In 2009, at the height of the reversal, deficit economies experienced net outflows of private capital (1.8 percent of GDP), offset by net inflows towards public instruments (3.1 percent of GDP). In surplus economies, net public flows always played a more important role due to the accumulation of foreign currency reserves in emerging Asia and in oil-exporting countries. Public flows nonetheless increased even further during the crisis. In 2010 for example, surplus economies' private net capital flows were zero and the net financial account consisted entirely of public flows.

⁴ There may be differences between the financial account and current account balances. Firstly, there is also a capital account, which we do not discuss here. Secondly, the data come from different sources, which are not necessarily mutually compatible. The balance of payments statistics include an “errors and omissions” item, which absorbs the difference between measured current and financial account transactions.

⁵ In this definition, a transaction between two private sector agents may be classified as a “public” flow if it involves a government security. This is the case for example of the sale of a US Treasury bill by a private American bank to a non-resident.

⁶ We include Spain in the G20.

Chart 3 Total net and private capital flows in G20 countries*(share as a % of GDP)*

NB: A net positive flow corresponds to a net capital outflow or a current account surplus. We include Spain in the G20.

Sources: IMF balance of payments, own calculations.

1|3|2 ... was partially offset by public capital flows

The findings above suggest that the adjustment of current account deficits could have been much sharper without public sector outflows and inflows. Strictly speaking, this is not necessarily the case: it is indeed possible for increased financing to the public sector to crowd out flows to the private sector. However, a few examples of individual countries, two with a current account deficit and two with a surplus, suggest that the resilience of public flows made it possible to avoid a sudden reversal of the current account balance (see Charts 4).

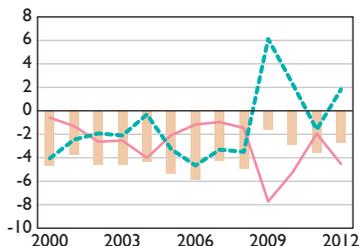
In the United States, inflows to public instruments and outflows from private instruments were probably a result of increased risk aversion and the “flight to safety”. In 2009 and 2010, non-residents exchanged their risky private assets for safe government assets. Public inflows over this period consisted mainly in purchases of US government debt securities, considered by the market to be the premier non-risk asset. Conversely, private financial instruments posted heavy outflows. The reversal of private financing flows between 2006 and 2009 amounted to 11 percent of GDP.

In Spain, net public flows, which accounted for most of the inflows in the first phase of the crisis in 2009 and 2010, were due mostly to the Government’s ability to continue to borrow on the international markets, even as credit to the private sector plunged. In the second phase, in 2011 and 2012, i.e. during the euro area crisis, the government also stopped borrowing on the international markets and the financial account quickly returned to a balanced position. This balance nonetheless masked massive private capital

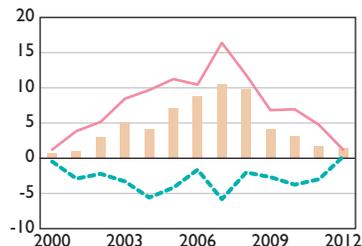
Charts 4 Total net capital flows in selected G20 countries

(share as a % of GDP)

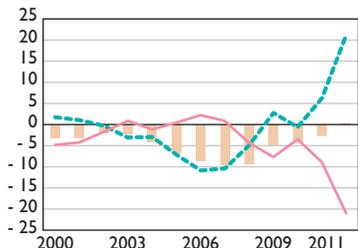
United States



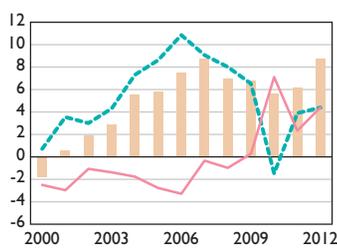
China



Spain



Germany



NB: A net positive flow corresponds to a net capital outflow or a current account surplus.

Sources: IMF balance of payments, own calculations.

outflows amounting to 21 percent of GDP in 2012. This was due to a reduction in Spanish banks' cross-border liabilities, financed by liquidity injected by the Eurosystem via Target2.⁷ Overall, the reversal of private flows between 2006 and 2012 peaked at a substantial 32 percent of GDP.

The German private sector has sharply cut back its cross-border lending post-crisis. Waning private flows have been offset by increased public capital flows to the rest of the world, which has enabled the financial account to remain stable. The public flows are made up mainly of Bundesbank claims on the Eurosystem via Target2, and to a lesser extent, an increase in government external assets as a result of loans within the framework of European Union aid programmes.

Unlike in the three previous examples, the structure of capital flows did not change in China, with outflows of public capital (accumulation of foreign currency reserves by the Central bank) and inflows of private capital (direct investment). Both of these flows decreased from 2007 until they achieved a position close to balance in 2012.

⁷ Target2 settles payment transactions between euro area central banks. Since the financial crisis, these transactions have partly replaced the interbank market: several periphery commercial banks in fact no longer have access to private financing and turn to their national central bank for financing. Symmetrically, core banks' excess liquidity is deposited with their national central banks, which hold Target2 claims. See for example, Higgins and Klitgaard (2011) or Bonhorst and Mody (2012).

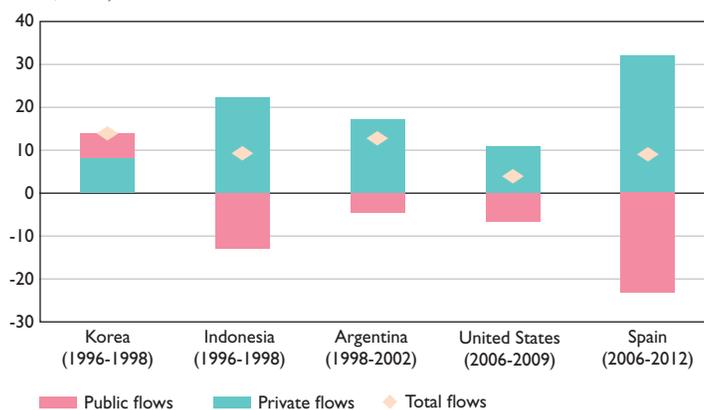
I|3|3 The buffer role of public flows

The resilience of public flows was instrumental in protecting the global economy from the consequences of a sudden and rapid adjustment of global imbalances. Capital outflows from public sectors of surplus economies (e.g. the accumulation of reserves in emerging markets) and capital inflows towards government securities of deficit economies (e.g. US Treasury bills) cushioned the shock provoked by the collapse of private flows. In the euro area, the provision of liquidity by the Eurosystem and the functioning of the payments system via Target2 offset dwindling cross-border inter-bank flows. Without the resilience of public capital flows, the adjustment would have been akin to the one that occurred during the emerging economy crises. Chart 5 compares the reversal in capital flows during the current crisis to the turnaround that occurred during the emerging market crises of the previous decade. While the overall adjustment of the financial account in the United States and Spain was less than that of the emerging economy crises, the adjustment of private flows was on the same scale.

For the United States, the continued accumulation of reserves in emerging Asia produced rather mixed “stabilising” effects. While the resilience of these flows towards public financial instruments helped to prevent the disorderly depreciation of the dollar, it also slowed down the real structural depreciation of the dollar, which should have accompanied the return to balance of the US economy and could have enabled external demand to take over from domestic demand. In the United States, which is an economy with a floating exchange rate that holds debts in its own currency,

Chart 5 Reversal in capital flows during crises

(in percent of GDP)



NB: A positive figure indicates a net capital outflow and an increase in the current account balance.
Sources: IMF balance of payments, own calculations.

nominal depreciation does not have the temporary negative impact that it is likely to have in emerging economies, where the depreciation of the national currency automatically increases the share of foreign-currency denominated debt.

Irrespective of the short-term trends, medium-term adjustment of global imbalances should come from the underlying rebalancing between the income and the spending decisions of economic agents, notably in the private sector (see Box). The section that follows takes a closer look at the demand rebalancing process.

Box

Current account, capital flows and demand imbalances

The current account is the sum of the balance of trade, which includes all cross-border transactions in goods and services, and the income balance, i.e. net income from the rest of the world (for example, returns on foreign direct investment, interest paid on bonds held abroad, etc.). An economy that has a trade surplus and a positive net income has a current account surplus.

As current transactions must be financed, the current account has its counterpart in the financial account, which is the balance of cross-border financial transactions. By definition, the sum of the two balances is zero:

$$\text{current account} + \text{financial account} = 0 \quad (1)$$

An economy with a current account deficit will necessarily have a financial account surplus: net positive capital inflows finance the current account deficit. Conversely, an economy with a current account surplus is accumulating assets abroad: it will have net capital outflows and a financial account deficit (see Charts 3 and 4).

$$\text{current account} = - \text{financial account} = \text{net capital outflows} \quad (2)$$

The current account may also be seen as the aggregate spending decisions of all economic agents in the country. It is equal to the difference between income and domestic demand:

$$\text{current account} = \text{national income} - \text{domestic demand} \quad (3)$$

Domestic demand is therefore weak in surplus economies and strong in deficit economies. At the global level, income is equal to both the gross domestic product and the sum of domestic demand:

$$\begin{aligned} \text{global GDP} &= \text{domestic demand of deficit economies} \\ &+ \text{domestic demand of surplus economies} \end{aligned} \quad (4)$$

.../...

Lastly, we define potential GDP, which corresponds to the production possibility of the economy, i.e. The amount that the economy can produce when all resources are fully employed. The output gap measures the relative difference between actual GDP and potential GDP. We therefore have:

$$\begin{aligned} & \text{domestic demand of deficit economies/global potential GDP} \\ & + \text{domestic demand of surplus economies/global potential GDP} \\ & = I + \text{output gap} \end{aligned} \quad (5)$$

Assuming constant national incomes, a reduction in current account imbalances implies a drop in the domestic demand of deficit economies and a surge in the demand of surplus economies [equation (3)]. Equation (5) illustrates the risk of an “asymmetric” adjustment: if the increase in domestic demand in surplus economies is lower than the decline in the domestic demand of deficit economies, the global output gap will widen (see Charts 6 below, which depicts this situation for the G20).

2| Rebalancing global demand: asymmetry constrains economic growth

2|1 The risk of an asymmetric adjustment...

One of the risks associated with global imbalances is that of “asymmetric adjustment”. While domestic demand decreases in deficit economies due to reduced leverage and the borrowing constraints imposed on debtors, no pressure is put on surplus economies to force them to increase their demand. If the decrease in demand in deficit economies is not offset by an equivalent increase in demand in surplus economies, the global economy experiences a demand deficit that leads to a recession and a global negative output gap (see Box). This asymmetric adjustment risk has been widely discussed in international forums. Addressing this risk is for instance one of the objectives of the “Framework for strong, sustainable and balanced growth” adopted by the G20 countries at the Pittsburgh summit in 2009. Deficit economies pledged to “support private savings and undertake fiscal consolidation” and surplus economies to “strengthen domestic sources of growth”.

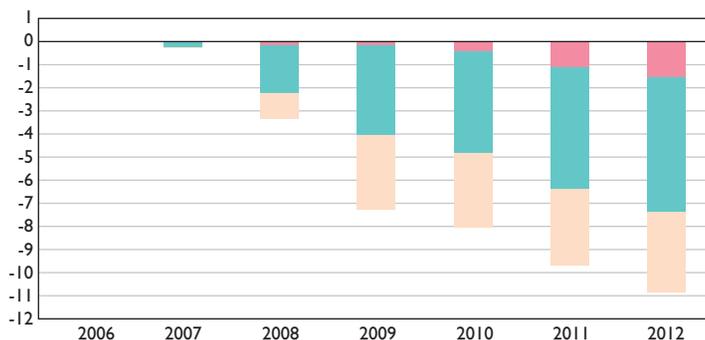
To show the state of progress of rebalancing and its symmetrical or asymmetric nature, Charts 6 depict the change in the three main components of domestic demand – private consumption, public consumption and total investment – since 2006. The components are represented in terms of potential GDP of G20 countries (including Spain), for deficit and surplus countries.⁸

⁸ It is not possible to distinguish between public and private investment for all G20 countries due to the absence of data.

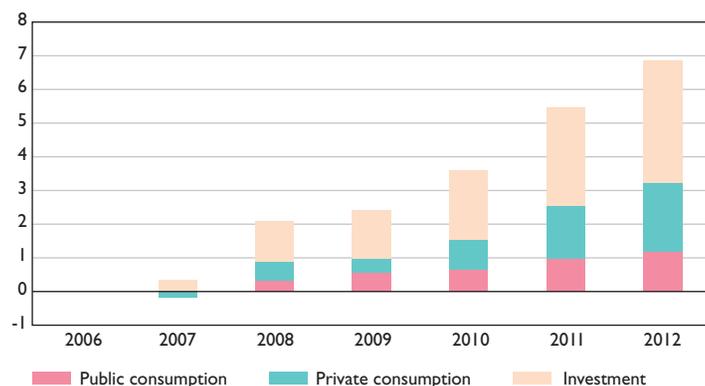
Charts 6 Change in the components of domestic demand in the G20 since 2006

(share as a % of potential GDP)

a) Deficit economies



b) Surplus economies



NB: A positive figure indicates a net capital outflow and an increase in the current account balance.
Sources: IMF balance of payments, own calculations.

Expressing components of demand in shares of potential GDP rather than actual GDP presents two advantages. First, it enables us to disregard the sharp swings in nominal GDP that occurred during the crisis.⁹ Second, as explained in the box above, the sum of changes in the domestic demand of deficit and surplus economies, expressed as a share of potential GDP, is equal to the change in the global output gap. To rebalance current accounts without widening the output gap, these changes must be equal in absolute values and opposite in signs. Charts 6 therefore clearly show the asymmetry of the adjustment.¹⁰ The disadvantage of using a measure of potential GDP is that this measure is highly uncertain. We use the IMF estimates reported in the *World Economic Outlook*.¹¹

⁹ An unchanging level of consumption would therefore automatically appear to be an increase during a recession if it is presented as a share of actual GDP.

¹⁰ In practice, the G20 does not represent the world as a whole and asymmetric adjustment may be offset by an improvement in the current account of the G20 as a whole. In this situation, the G20 would benefit from an increase in demand from the rest of the world.

¹¹ For Saudi Arabia, we use our own calculations based on a Hodrick-Prescott filter. If IMF estimates were to overestimate potential GDP of deficit economies, the chart would overestimate the drop in the share of domestic demand of deficit economies and underestimate the rise in the share of domestic demand of surplus economies.

2|2 ... has materialised

Deficit economies largely rebalanced their domestic demand, while in surplus economies domestic demand increased modestly.

Three lessons may be learned from this exercise.

First, there was indeed a narrowing of the demand imbalances driving global imbalances. Measured as a share of the potential GDP of G20 countries, domestic demand shrank in deficit economies and expanded in surplus economies.

Second, the adjustment was asymmetric. Demand contracted by 11 percent of G20 potential GDP in deficit economies but grew by only 7 percentage points in surplus economies. All else being equal, the output gap thus increased by 4 percentage points. According to IMF data, the output gap of G20 countries as a whole worsened by 3.4 percentage points between 2006 and 2012, and 3.7 percentage points between 2006 and 2013. The difference is due to the fact that G20 countries benefitted from an increase in demand from the rest of the world, by about half a point between 2006 and 2012. The asymmetric adjustment was therefore partly responsible for weak global growth. This asymmetric adjustment was also observed in the euro area.¹² We must however consider the fact that G20 economies were possibly overheating in 2006. Part of the increase in the output gap would therefore be consistent with a return to normal economic conditions. According to IMF estimates, G20 countries had a positive output gap of slightly less than one point in 2006.

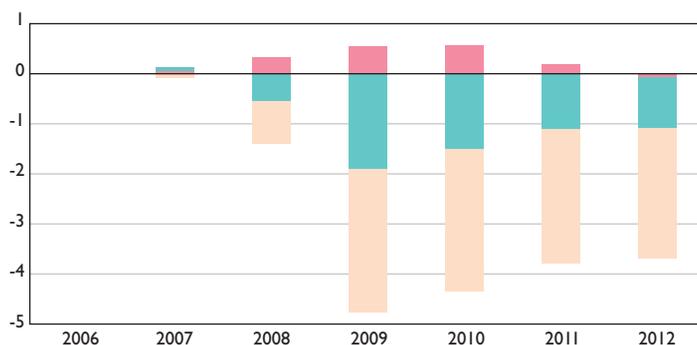
Third, it is interesting to observe that the adjustment is more reflective of a change in the geographical composition of the G20 GDP than an internal rebalancing within each member country. Surplus economies posted a higher growth rate than economies running a deficit, mainly due to China's strong growth. From 2006 to 2013, surplus economies' potential GDP rose from 34% to 42% of potential GDP of G20 countries. Therefore even if surplus economies' domestic demand remained stable as a proportion of their own GDP, this demand would account for a larger share of G20 GDP. Charts 7 show the change in domestic demand components without this effect, i.e. maintaining the geographical composition of potential GDP of G20 countries unchanged at its 2006 level: only the deficit economies significantly rebalanced their domestic demand by close to 4 percentage points, while the increase in domestic demand in surplus economies remained below one point. The sharp drop in investment in deficit economies undoubtedly contributed to the lacklustre international trade over this period, due to the high import intensity of investment (Bussière *et al.*, 2013).

¹² See Berthou and Gaulier (2013).

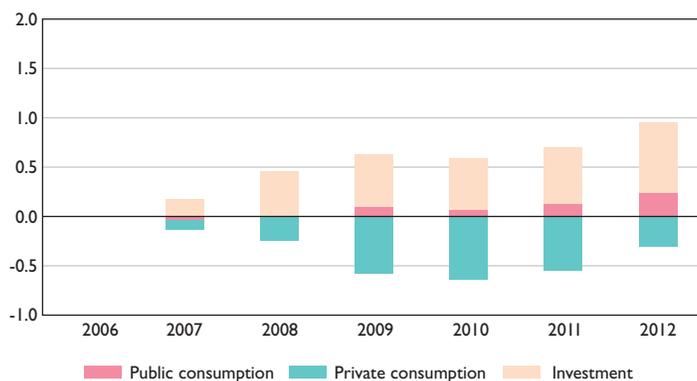
Charts 7 Change in the components of domestic demand in the G20 since 2006, assuming a constant composition of G20 GDP

(share as a % of potential GDP)

a) Deficit countries



b) Surplus countries



Note: We include Spain in the G20.

Sources: IMF WEO, national sources, own calculations.

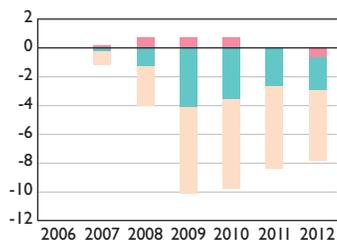
The change in the domestic demand of countries taken individually illustrates the asymmetric adjustment even further. If we consider the United States and Spain, which are two examples of deficit economies (see Charts 8), we note substantial rebalancing in both countries. In 2012, the share of private consumption and investment in US potential GDP was 7 percentage points smaller than in 2006, due mainly to private sector deleveraging. In Spain, this share was 13 percentage points lower than in 2006, due to slackened investment. The share of public consumption as a percentage of potential GDP remained relatively stable in both countries, dampening the negative impact of receding private demand on output.

In surplus economies, the situation was more varied. In China, rebalancing is taking place, driven by rising investment. In Germany, the share of domestic demand in potential GDP was smaller in 2012 than in 2006: the imbalance therefore increased slightly. It is worth noting that in both countries, rebalancing

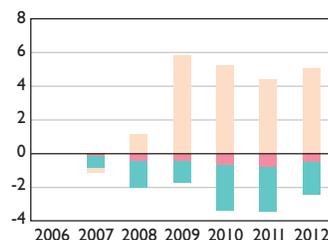
Charts 8 Change in the components of domestic demand since 2006

(share as a % potential GDP)

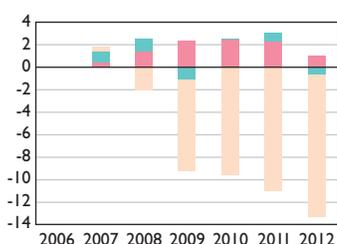
United States



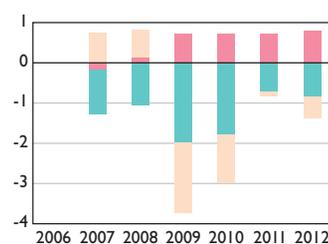
China



Spain



Germany



NB: A net positive flow corresponds to a net capital outflow or a current account surplus.

Sources: IMF balance of payments, own calculations.

is mainly a result of government policy. The upsurge in investment in China is largely driven by a stimulus policy and investment in infrastructure. In Germany, public consumption is the sole component of domestic demand that has increased since 2006, by almost one point of potential GDP. However, the share of private consumption has dropped in both countries since 2006: by one percentage point in Germany and two percentage points in China. Savings behaviour and private spending were therefore not rebalanced.

The adjustment of domestic demand, especially private demand, in surplus economies, is not a given. The motives prompting households in surplus economies to save are real: demographic changes, lack of social safety nets and depletion of natural resources. But regardless of how well-founded it is, the *ex ante* intention to save still requires investment or borrowing decisions to result in *ex post* savings behaviour. Pre-crisis investment and borrowing of deficit economies turned out to be risky and these countries are also increasing their savings. Theoretically, the adjustment should come from a drop in global real interest rates – a drop that is substantial enough to stimulate investment and discourage savings. But with policy rates close to zero in the major advanced economies, such an adjustment appears to be impossible.

The alternative is therefore to tackle the problem directly at its source by reducing the motives for saving in surplus countries. This is the rationale behind current international debate on the structural reforms that could

facilitate rebalancing in forums such as the G20. For example, the introduction of social safety nets in China could help to curtail households' precautionary savings and thus contribute to rebalancing the global economy.

3 | Conclusion

The ability of open economies to lend or borrow externally, i.e. run current account surpluses or deficits, offers precious flexibility in the management of macroeconomic growth. For example, it enables an economy to cope with population aging by accumulating assets abroad, to take full advantage of a high potential output growth by borrowing externally, or, for exporters of commodities, to smooth national consumption in the event of temporary price fluctuations. However, the current account imbalances that widened in the 2000s were surprising in their magnitude and the unusual direction of capital flows, with high-growth emerging economies lending massively to advanced economies.

These significant imbalances present three types of risks. Firstly, the accumulation of current account deficits is often the counterpart of a sharp rise in private sector leverage, associated with asset price bubbles and increased financial fragility. This risk materialised: the global financial crisis, which started with the downturn in the US housing market in 2007, mostly affected economies with substantial current account deficits.

The second is that of an abrupt and disorderly reversal of capital flows that could lead to wide fluctuations in asset prices and exchange rates. This second risk materialised only partially. While capital flows from and to the private sector indeed plummeted and even reversed in a movement similar to that observed in crises in emerging economies in the previous decade, public inflows and outflows partially took over. The fall in asset prices was limited to risky private securities and the dollar crisis feared in the 2000s did not occur.

The third risk is that of an asymmetric adjustment of demand between deficit and surplus economies. This risk also materialised and it is likely that the asymmetric adjustment is partly responsible for the slowdown in global growth. Nonetheless, public consumption remained stable in deficit countries, while government policies in surplus countries drove an upsurge in public consumption and investment, which limited the slide in global economic growth.

Until now, public capital flows and government policies have made it possible to avoid the disorderly narrowing of global imbalances in the short term. In the medium term, the challenge facing economic policy is to facilitate the structural rebalancing of private sectors so as to enable growth in domestic demand in surplus economies while consolidating the increase in savings in deficit economies.

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