

January 24, 2011

Global

Emerging Issues

Current Account Reversals

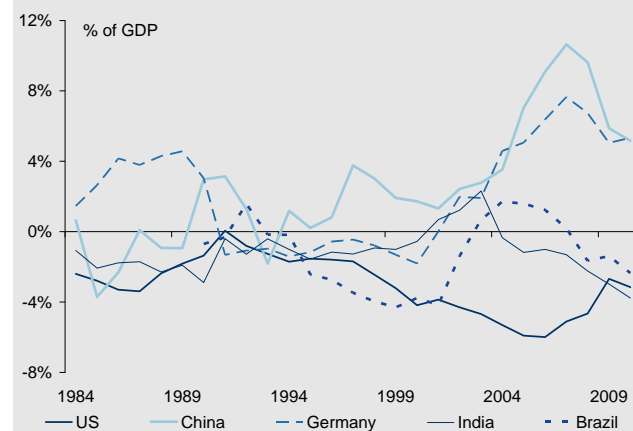
Global rebalancing is underway, but still quite a distance from being done. In this note, Manoj Pradhan, Alan Taylor and Patryk Drozdziak examine the dynamics of current account reversals.

Mix of surpluses and deficits: Rather than the historical norm of deficits seen in past decades, EM economies are now running a mix of surpluses and deficits. In addition, the deficits are more sustainable because a significant part of the deficit is funded by long-term, more stable FDI flows.

Capital inflows remain important: However, accumulation of FX reserves by EM central banks means that investment exceeds 'available' saving in most economies, and hence private capital inflows into EM are still important. Reserves will probably continue to grow in line with the size of the economy or the financial sector, so foreign investment should remain a key ingredient for EM growth.

150 years of economic history suggests that EM's role in rebalancing unlikely to hurt: As if they needed any, there's more good news for EM economies. Looking at 80 instances of large current account reversals for 15 countries over 150 years suggests that current account surplus reversals historically seem to have very little pain associated with them, which should assuage AXJ economies wary of the rebalancing underway. The scope for a painful correction of EM current account deficits seems less likely to us, given that countries with strong fundamentals, substantial precautionary reserves and attractive long-term investments like India, Brazil, Turkey and Poland are among the countries running current account deficits.

Global Rebalancing Is Underway



Source: Haver Analytics, Morgan Stanley Research

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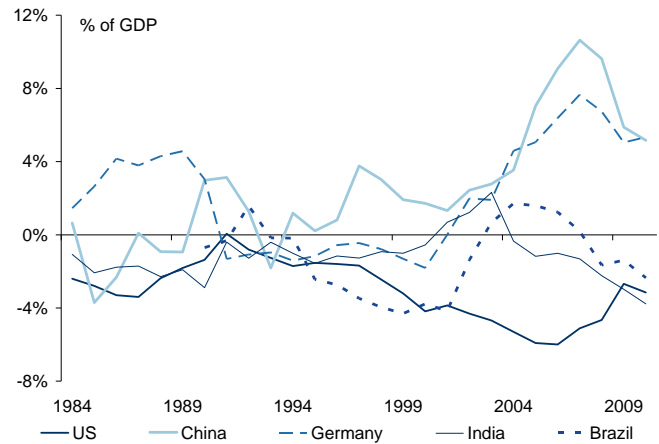
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- **EM role in rebalancing unlikely to hurt:** As if they needed any, there's more good news for EM economies in that current account surplus reversals historically seem to have very little pain associated with them, which should assuage AXJ economies wary of the rebalancing underway. The scope for a painful correction of EM current account deficits seems less likely to us, given that countries with strong fundamentals, substantial precautionary reserves and attractive long-term investments like India, Brazil, Turkey and Poland are among the countries running current account deficits.

A Difficult Rebalancing Act?

The unwinding of current account imbalances has spelt trouble for emerging markets (EM) in the past, but not this time around. EM economies as a whole are running a mix of current account (CA) surpluses and deficits and even running an overall surplus. Not that they really need it, but this spells good news for emerging economies if a century-and-a-half of economic history is anything to go by. A look at current account reversals for data spanning from 1870 for 15 countries comprising 80 episodes of 'large' current account surplus and deficit reversals suggests that current account surplus reversals tend to be much more benign than deficit reversals.

Exhibit 1
Global Rebalancing Is Underway



This does raise concerns about some economies whose deficits have recently been widening, but the list includes EM economies with strong fundamentals such as India, Poland and Turkey, which means that they are likely to withstand the unwinding fairly well. Global rebalancing therefore seems to carry greater risk for the developed world where CA deficits are more common, rather than the EM world where surpluses are easier to find.

One direct consequence of the large CA surpluses in EM that attracted quite a lot of attention, particularly in the US, before the crisis was the 'uphill' flow of capital from EM economies to DM capital markets. These flows came not just from economies running CA surpluses, but also from the large FX reserves held by central banks in both CA surplus and deficit economies. Clearly, these public savings are not scheduled to be used for financing domestic investment. Thus, even though aggregate saving exceeds investment in CA surplus economies, which is always the case, the level of 'available' saving (saving net of public saving in the form of FX reserves) falls short of investment in both CA surplus and deficit countries. EM economies will thus continue to need capital inflows even though their aggregate saving position may mask the need for these inflows.

The global imbalance problem has not gone away, but adjustment is taking place gradually and may be expected to continue, especially as EMs mature onto a path of faster growth and a less voracious approach for reserve accumulation. Understanding the process requires looking

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behind the simple saving-investment balances, and beyond the aggregate EM picture, to consider individual country gross and net flows, and the likely dynamics of reversals for surplus and deficit regions.

Interpreting Current Account Imbalances

The CAB as a Saving-Investment Relationship...

The current account has interpretations beyond the basic definition of the excess of exports over imports (plus net service income and transfers). Using national income accounting relationships, the current account is also identical to the saving-investment gap. If domestic saving (public and private) exceeds domestic investment, the excess translates directly into a current account surplus, usually resulting in capital outflows (lending to foreigners) and the opposite for a current account deficit.

...or as an Intertemporal Choice

The current account balance, however, can also be interpreted as the manifestation of intertemporal choices. Economies that are experiencing a medium-term growth spurt could run current account deficits, borrowing from the rest of the world against future returns. In a similar vein, countries concerned about shocks to exports, financing, capital flight or speculative attacks on the currency may run current account surpluses in order to build a precautionary stockpile of (public) saving.

Thus, rather than view current account balances solely as a mechanical difference between international payments for exports and imports and the like, we can gain greater insight if look at them from the saving-investment point of view or from the intertemporal perspective.

CABs in EM: A Mix of Surpluses and Deficits

In keeping with the idiosyncracies involved in analysing emerging markets, the pattern of current accounts across the EM world also refuses to conform to a uniform pattern. Rather than running stereotypical current account deficits, the EM world has a mix of countries with surpluses as well as others with deficits (see Exhibit 2). For example, the AXJ economies (with the notable exception of India) have been running current account surpluses since the Asian Financial Crisis of the late 1990s prompted a sea change in external policy. On the other hand, the CEEMEA and LatAm regions have more of a mix of surpluses and deficits.

Exhibit 2

CA Surpluses and Deficits: Half and Half

CA Balance (CAB) and Basic Balance (BB) (% of GDP, BB = CAB - Net FDI)			
	CAB	BB	PPP weight (%)
Positive CAB and BB			
Malaysia	12.5	8.8	1.3
Taiwan	10.0	8.4	2.4
Hong Kong	6.6	3.6	1.1
China*	5.2	7.5	32.2
Russia	5.2	4.3	7.3
Thailand	4.5	5.7	1.9
Israel	4.2	1.2	0.7
Korea	2.7	8.6	4.7
Argentina	1.4	2.6	1.9
Indonesia	1.3	2.4	3.4
Chile	1.2	5.2	0.9
Hungary	1.2	1.6	0.6
Negative CAB, Positive BB			
Mexico	-0.4	0.2	5.1
Ukraine	-0.9	2.8	1.0
Peru	-1.0	3.1	0.9
Czech Rep.	-2.6	2.7	0.9
Colombia	-2.8	2.0	0.7
Negative CAB and BB			
27.6			
Brazil	-2.4	-0.9	7.0
Poland	-2.8	-1.2	2.4
SA	-3.3	-3.5	1.7
India	-3.8	-2.9	12.7
Turkey	-5.2	-4.6	3.0
Romania	-5.3	-3.7	0.9

Source: Haver Analytics, Morgan Stanley Research; Note: Data NSA, 4Q rolling basis; *YTD data used in; calculating CA and BB for China; **2Q10; otherwise 3Q10.

Given the asymmetries inherent in the financial positions of countries, the necessity for adjustment is quite uneven. A surplus country worried about inflation or exchange rate appreciation will not be keen to accept much if any of the burden of adjustment (e.g., Germany, China) and instead will prefer to force the burden of adjustment on the deficit country (e.g., euro-zone peripherals or the US). And if the exchange rate is fixed between the two sides (by a common currency link or a peg) then the deficit country will face damaging imported deflation (e.g., Ireland). In this respect, the fact that current tensions over imbalances and exchange rates are at their most intense in the 'fixed-rate blocs' of US-Asia and the euro-zone echoes the analogous tensions seen during the inter-war gold standard and (to a lesser extent, given limited capital mobility) under the Bretton Woods regime.

At the height of the boom before the Great Recession, current accounts were at their most imbalanced levels. Since then, some rebalancing has already started. However, EM rebalancing this time around is not quite going to be the typical, sharp narrowing of current account deficits as was the case in the past. Rather, with both surpluses and deficits in the EM world, both will likely narrow but the magnitude of the shifts will be obscured in the aggregate EM total. Looking at an overall measure of EM imbalances is therefore likely to be misleading, and is likely to exhibit less rebalancing than a focus on individual country accounts would show.

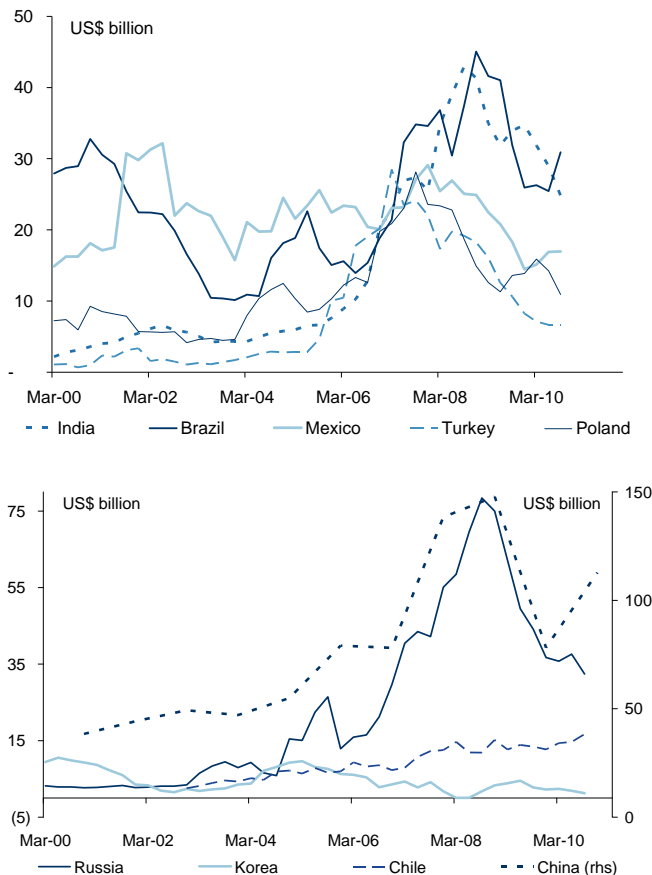
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EM CAB Reversals: Benign Rebalancing for Some...

If a build-up of current account surpluses and deficits means an increasing excess of saving or investment and vice versa, then the reversal of these imbalances will mean that the saving-investment gap will begin to close. In cases where the imbalance was a result of destabilising excesses, a rebalancing of the saving-investment gap will be salutary. Prime examples of such destabilising excesses were the consumption-fuelled current account deficits in the CE3 region. The pressure this created on the Hungarian forint in particular precipitated a rapid drive of the current account deficit into surplus territory. At the other extreme, a more benevolent type of rebalancing from export and investment-driven growth to a more consumption and domestic demand-driven one appears to be on the cards for China.

Exhibit 3
FDI Inflows: Surplus and Deficit



Source: Haver Analytics, Morgan Stanley Research; Note: For China, annual data, 2Q10 YTD annualized for 2010 uptick.

...but Delayed Investment for Others

However, in some economies where CA deficits were driven by healthy spurts in investment, a shift towards rebalancing could mean that some investments have to be pursued at a slower pace, at least for a while. Exhibit 3 shows that FDI inflows into EM economies have been uniformly high in both surplus and deficit countries (showing the excess of investment over 'available' capital being financed by FDI inflows). FDI inflows have clearly fallen in many countries from their pre-crisis levels. As the recovery in the DM world solidifies and growth in the EM world becomes more sustainable, these FDI flows should resume as a steady flow back into the EM world.

Rebalancing Is Already Underway

The Great Recession, like previous global financial crises, has led to a reduction of global imbalances. Current account imbalances have rebalanced across a wide swathe of EM economies. Exhibit 1 shows that both deficit and surplus current account positions have moderated. In addition, a larger part of the deficits are now financed by stable, long-term foreign direct investment (FDI) flows, which reduces the dependence on portfolio flows (PF) as well as foreign borrowing. Exhibit 2 shows a positive 'basic balance' (defined as the current account less net FDI flows) for most countries in the EM world, where a positive number suggests that the CA is fully financed by FDI flows while a negative balance shows the amount that needs to be financed through either PFs or external borrowing. While the split between countries running a positive and negative CAB is fairly even, nearly three-quarters of EM economies under our coverage run a positive basic balance. The historical reliance on PFs as well as the concern surrounding a sudden reversal in these flows is thus no longer a worry for a large chunk of the EM world.

There are some notable and rather prominent exceptions. The widening of current account deficits as well as the basic balance in India, Brazil, Poland, Turkey and South Africa is worth highlighting. A widening deficit suggests a renewed shortfall in saving relative to investment at a time when central banks are building up reserves again. In aggregate, public saving is rising but available saving could be falling at a more rapid rate relative to investment. As FDI inflows have yet to recover to pre-crisis levels, it is no surprise that the basic balance has deteriorated, implying greater reliance on PFs and/or external borrowing. It is somewhat ironic that the most vocal agitator against capital inflows, Brazil, is in the category of countries that relies on capital flows more than most other EM economies.

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- **India:** India's current account deficit for the quarter ending September 2010 clocked in at 3.8% of GDP. Our India team, however, believes that the widening trend was due to low real rates and loose fiscal policy pushing down saving relative to investment. The ongoing reversal of monetary and fiscal laxity and a build-up of capacity from investment will reduce the saving-investment imbalance and bring the current account closer to balance. If FDI flows remain steady, this should mean that the basic balance (currently in negative territory) will improve as well.
- **Brazil:** After running a CA surplus between 2004 and 2007, Brazil has moved back to a CA deficit. While FDI inflows have picked up again recently, they have been outstripped by the widening of the CA deficit, implying a greater reliance on PFs and external borrowing. Our Brazil economics team expects this situation to worsen in 2011 with a further widening of the CA deficit (see [Latin America in 2011: Risks to Abundance, Risks of Abundance](#), December 6, 2010). BCB President Meirelles remarked recently that the CA deficit was a fundamental counter-balance for a stronger currency in the medium term. In the short term, however, Finance Minister Mantega's frustration with the strong currency has meant capital controls to stem PFs which are, at the moment, more than what is needed to finance the shortfall in the basic balance – a situation that is quite common across many EM economies.
- **Poland:** Poland's CA analysis suffers from a rather large 'errors and omissions' number. This could mean that the CA is actually quite negative and would mean that the basic balance is also large and negative (see [CEEMEA Balance of Payments: Digging Deeper](#), October 4, 2010). With the exception of a couple of quarters, both consumption and investment in Poland have remained strong, aided by expansionary monetary and fiscal policy. Looking forward, strong fundamentals mean that a CA deficit is likely a feature that will persist in Poland.
- **South Africa:** South Africa has a history of reliance on capital flows as well as lower saving relative to investment. With the basic balance in negative territory, this implies a greater reliance on PFs and greater volatility in the exchange rate. The CA deficit is likely to persist for a while due to the chronic shortage of domestic saving. Further, with the SARB likely to build up its FX reserves, 'available' saving should remain below aggregate saving, suggesting further reliance on capital inflows.
- **Turkey:** Turkey's current account deficit throws up a mixed picture. The deficit is driven mostly by oil and natural gas exports, and no immediate relief can be expected on that front, but the reliance on energy imports will likely decline gradually as Turkey's nuclear programme kicks in over 5-7 years. The drop in FDI has stabilised but is well below pre-crisis levels, so reliance on PFs and/or external borrowing has increased. As partial relief from that reliance, Turkey's better economic fundamentals have allowed Turkish companies to borrow on better terms. From a saving-investment perspective, a shortfall of saving relative to investment is likely to persist, as will a current account deficit funded by strong fundamentals and a positive outlook for Turkey's future.

The Dynamics of Current Account Adjustment

In our previous note (see [Emerging Issues: Capping Current Accounts: Squeezing Toothpaste with the Cap On](#), November 30, 2010), we considered the determinants of current account equilibrium in the long run, and in particular the influences on national saving and investment that may explain the pattern of international capital flows. However, despite the tendency in the data for the current account to stabilise in the long run, current accounts can fluctuate and diverge significantly from these paths in the short run. History shows that many different causal factors may lead to such deviations:

- Shocks to (actual or perceived) investment opportunities at home or abroad which cause investment to flow in or out in response;
- Shocks to expenditure at home or abroad (e.g., temporary financing to cover a war or emergency);
- Shocks to policy which affect demand directly via expenditure or indirectly via the asset markets (exchange rates and/or interest rates);
- Shocks to external capital market access which reduce the gross inflow of capital and necessitate an external adjustment to close a CA deficit;
- Shocks to confidence at home which lead to capital flight and which increase the gross outflow of capital, implying similar CA adjustment.

All these shocks are potentially reversible, of course, so the impact on CA can go either way. A perceived investment opportunity might cause capital to rush in; subsequent 'news' suggesting that returns could disappoint might trigger a capital exodus. Similarly, man-made fluctuations can result from policy reversals.

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In this way, CA dynamics can be subject to the same kind of boom-bust cycles as investment in a closed economy. The only difference is that because these flows of investment cross borders, they create links of inter-dependence between economies and raise issues of a political economy nature (e.g., policy choices about capital controls and the monetary regime) that are absent in the autarkic setting.

Do Imbalances Matter?

In the past, some have argued that current accounts really should be paid little to no attention because current account adjustments can occur very smoothly without any necessary adjustments in exchange rates (Williamson's 'Immaculate Transfer' theory) or that current accounts are not a worry as long as they are used to finance private investment or consumption decisions (the 'Lawson Doctrine'). The Immaculate Transfer theory falls short in a world where imperfections like non-traded goods and limited substitutability among goods ensure that real exchange rates will adjust in line with fundamentals, as they are already for the main protagonists of the rebalancing story. The Lawson Doctrine may appear to work for some resource booms but it fails to convince, given the recent scars of overconsumption and malinvestment booms in assorted DM economies. Ignoring current accounts seems dangerous, but so does thinking of current accounts themselves as the cause or the solution of global imbalances. Rather, they are a good barometer of underlying fundamentals that may need rebalancing.

Some time ago, many of these considerations might have been confined to a discussion of the trends and cycles in current accounts in the EM space. However, following the emergence of global imbalances and the boom-bust cycle in DM economies, our perspectives have changed. After the humbling crisis, the DM versus EM differences are not so stark. Now DM economies also have to grapple with issues of financial sector and sovereign fragility, and the question of current account sustainability looms larger. Thus, the lessons from comparative economic research for how current accounts rebalance can be applied more broadly going forward.

Current Account Reversals in History

As with many other important macroeconomic phenomena, current account reversals can be thought of as a type of 'rare event' – which means that for serious empirical analysis, especially on a small sample of countries like the DM subset, a look back over the very long sweep of history is needed to glean any meaningful and robust statistical patterns. To that end, we have examined DM current account reversals from 1870 to 2008, classifying them according to the direction and duration of the reversal process, as well as the observed

patterns of adjustments in domestic consumption, investment and output growth.

Exhibit 4 shows descriptive statistics for 81 CA reversals in this eight-country sample, consisting of 37 surplus reversals and 44 deficit reversals. The evidence here buttresses the argument that deficit reversals are typically more painful than surplus reversals. A typical reversal lasted 4.2 years, and the average growth rates of real GDP, investment, and consumption were 1.9%, 2.5% and 1.5% per annum across all reversals, respectively. There was little difference in the duration of deficit and surplus reversals, but they differed markedly in terms of real outcomes. For surplus reversals, the average growth rates of real GDP and consumption were both equal to 2.4%, and investment growth was a very robust 5.6%. In contrast, for deficit reversals, the average growth rates of real GDP and consumption were much lower, 1.5% and 1.0%, respectively, and investment growth was severely retarded to -0.6%. The very low real consumption growth and negative investment growth figures indicate that deficit reversals were accomplished by a sharp compression of private absorption, in contrast to surplus reversals, and no doubt the collapse of investment was also a key driver of the more sluggish growth response. Finally, the time taken for reversals, both deficits and surpluses, varies somewhat but averages just over four years.

Exhibit 4

Current Account Reversals Over the Last 150 Years

CAB reversals, 1870-2008

Ave CAB	Absolute size of CAB reversals									
	CAB reversals			Surplus reversals			Deficit reversals			
	#	Rever.	T	#	Rever.	T	#	Rever.	T	
UK	2.3%	10	6.0%	5.8	7	6.4%	5.6	3	4.9%	6.3
US	1.3%	7	4.1%	7.4	3	4.7%	6.7	4	3.7%	8.0
GER	1.7%	5	4.4%	4.0	4	3.9%	4.0	1	6.1%	4.0
FRA	2.1%	8	6.3%	3.5	5	5.6%	4.0	3	7.5%	2.7
AUS	4.5%	17	6.7%	2.1	1	9.5%	2.0	16	6.6%	2.1
JPN	0.9%	4	2.6%	3.0	3	2.4%	3.3	1	3.0%	2.0
CAN	3.7%	14	5.2%	3.9	3	6.2%	3.3	11	4.9%	4.0
NLD	4.1%	16	9.8%	3.7	11	9.1%	3.7	5	11.2%	3.6
Total	2.6%	81	5.6%	4.2	37	6.0%	4.1	44	6.0%	4.1

Ave CAB	Real GDP, investment & cons. growth rates during CAB reversals									
	CAB reversals			Surplus reversals			Deficit reversals			
	GDP	C	I	GDP	C	I	GDP	C	I	
UK	2.3%	1.7%	1.3%	2.9%	1.6%	1.4%	4.0%	1.9%	1.1%	0.1%
US	1.3%	1.8%	1.5%	1.0%	2.1%	1.2%	3.8%	1.6%	1.7%	-0.3%
GER	1.7%	1.0%	1.7%	2.3%	2.4%	2.6%	7.5%	-4.8%	-2.2%	-13.0%
FRA	2.1%	1.5%	-0.5%	0.9%	1.0%	-1.0%	-0.7%	2.4%	0.3%	4.2%
AUS	4.5%	0.9%	0.1%	1.7%	3.6%	6.2%	6.2%	0.8%	-0.5%	1.5%
JPN	0.9%	4.1%	4.1%	5.1%	3.2%	3.3%	4.7%	6.7%	6.6%	6.3%
CAN	3.7%	1.8%	1.5%	1.2%	3.2%	2.6%	13.6%	1.5%	1.1%	-2.2%
NLD	4.1%	2.1%	2.1%	4.5%	2.3%	3.1%	5.7%	1.8%	0.0%	1.1%
Total	2.6%	1.9%	1.5%	2.5%	2.4%	2.4%	5.6%	1.5%	1.0%	-0.3%

Source: Company data, Morgan Stanley Research; Notes: T = years, # = number of episodes

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More Recent Evidence on Reversals

While sudden current account deficit reversals were seen widely in the EM world in the 1970s to the 1990s, current account deficits more recently in the industrial economies have become the focus of attention. Some common features in current account reversals stand out in both DM and EM economies (see Sebastian Edwards, *The End of Large Current Account Deficits*, 2005), and the effects of such reversals on an economy's macroeconomic trajectory are profound. Monetary and financial conditions tighten, the currency weakens, and real growth is significantly retarded. Some of these effects are noticeably more pronounced in large and less open economies where the desired adjustment size inevitably constitutes a larger fraction of the external trade flows.

Ironically, in the global rebalancing we face now, these findings are of more interest to DM observers than to the EM world. While the EM world does have a split of surplus and deficit nations, the sustainability of deficits in EM economies much more assured than it has been in the past. Part of this is due to the accumulation of 'rainy day' reserves to backstop macroeconomic and financial policies in hard times.

While current account surplus reversals appear to be less pressing, the global current account balance must be in balance too. Thus, current account deficit reversals must perforce be accompanied by current account surplus reversals some place else. Broaching this topic has triggered considerable resistance, with the surplus countries also arguing that this kind of reversal will be painful for them, that it could damage growth, especially in their cherished export sectors.

Empirical evidence from an IMF study (*World Economic Outlook*, April 2010, Chapter 4) suggests that adjustment during a surplus reversal tends to be very benign, with domestic demand rising, little change in export performance, and imports taking up most of the slack (directed about equally between additional investment goods and additional consumption goods). In the context of sharing the worldwide burdens generated by a resolution of global imbalances, surplus countries seem likely to escape very lightly indeed compared to deficit countries, a factor that may shape any future geopolitical bargains in this area.

'Uphill' Flows and 'Available' Capital

Bucking the Historical EM-DM Relationship

Economic theory suggests that excess saving should flow to areas where risk-adjusted investment opportunities abound. Drawn by investment-led growth in the EM world, capital should then flow 'downhill' from the developed countries to the fast-growing EM economies. The trend for capital from DM

economies to flow into EM economies has indeed prevailed at certain times, but the story has refused to stay as simple and clear-cut as that. In our [Capping Current Accounts](#) note, we have shown that a pattern of advanced, high-saving, rich countries running CA surpluses and financing current accounts and growth in EM economies did sometimes exist.

Exceptions to the Rule: EM Surpluses...

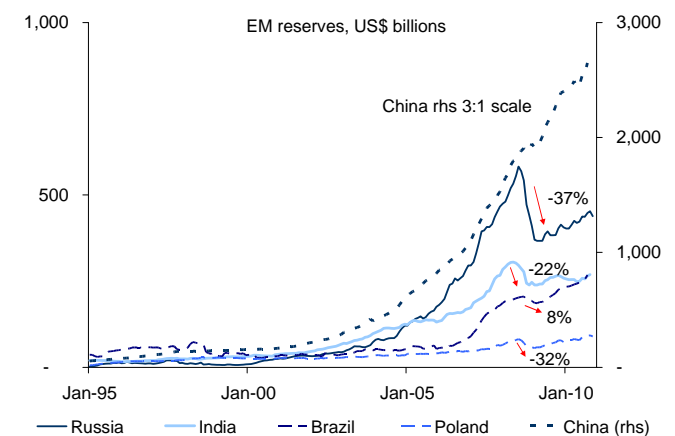
Yet, as with all 'rules', exceptions have sometimes appeared, and the exceptions over the last two decades have been far more widespread. The exceptions have taken two forms: first, EM economies have grown rapidly but some of the fastest-growing ones have run current account surpluses rather than deficits; second, in aggregate, capital seems to have flowed 'uphill' from EM economies to DM economies, rather than the other way around – the so-called 'Lucas Paradox'. But a simple interpretation may help us to understand why these seemingly contrarian capital flows have appeared.

...and a War Chest of Reserves

In the last 10-15 years, EM policy-makers appear to have actively pursued a policy of accumulating FX reserves as part of a self-insurance policy (see Exhibit 5). The objective was clearly to build a war chest of funds big enough to fight off a speculative attack on the currency, or a reversal of portfolio flows, or even provide insurance against shocks to the domestic economy (see Obstfeld et al., *Financial Stability, the Trilemma, and International Reserves*, 2010). While reserves fell in some countries during the crisis, they proved more than adequate to ward off speculative pressures until markets were convinced that EM did not share the ills of the DM world.

Exhibit 5

The 'War Chest' of FX Reserves Served EM Economies Well



Source: Haver Analytics, Morgan Stanley Research

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That this strategy has succeeded is evidenced by the fact that the relevance of an institution like the IMF was in question before the financial crisis, and yet thus far the EMs have avoided any need to approach the IMF or other external sources of aid. Remarkably, in this cycle, no EM country has suffered a severe recession, or any flavour of banking/currency/default crisis.

Aggregate versus 'Available' Saving

The policy of accumulating FX reserves amounts to a policy of generating public saving that will not be put to use in the domestic economy. The effective saving-investment balance in the economy thus has to be satisfied by saving net of the accumulated reserves. In turn, this means that domestic investment outstrips available saving so that foreign private capital inflows are required to bridge the shortfall. At an aggregate level, however, the sum of public and private saving could well be larger than investment, which translates into a current account surplus.

Public Saving and 'Uphill' Flows

The policy of reserve accumulation also explains why aggregate capital flows have gone 'uphill' (i.e., from EM economies into DM economies). The objectives of reserve management have been to keep the capital invested in relatively safe and liquid assets, primarily in the form of fixed income securities in the G10 economies, especially US government securities. 'Downhill' flows (from DM to EM economies) continue in the form of FDI and portfolio flows, which are market-based flows that move much more in accordance with economic theory, but these flows have been more than offset by the 'uphill' policy-driven flows sent out from the EMs to accumulate reserves.

The task of managing public saving and reserves in EM economies has undoubtedly been the single most important factor driving aggregate flows 'uphill' in recent times. Country-level evidence on current accounts and FDI inflows shows that FDI flows into both surplus as well as deficit countries have fallen after the Great Recession; they have revived in some places or are steady at lower levels in others. In other words, the inflow of long-term capital has continued to pursue investment opportunities regardless of the whether the country is a saving-abundant (and hence in current account surplus) economy or a saving-deficient one (with a current account deficit).

Summary

Global rebalancing is already underway and the pattern of current account surpluses and positive 'basic balances' across a large part of the EM world means that the rebalancing is likely to bring less pain there than the historical norms would suggest. The EM world has remained in overall CA surplus, even without China's contribution.

Learning from the EM crises of the 1980s and particularly from the Asian Financial Crisis of the 1990s, EM economies have used these surpluses as opportunities to build up FX reserves. These large public savings mean that aggregate saving relative to investment remains in positive territory. However, since reserves purchased by central banks are not used to finance domestic investment, the 'available' saving in the economy remains in shortfall relative to investment. Capital flows into the EM world therefore remain an important ingredient in the long-term growth story there.

EM economies avoided a severe downturn thanks to better fundamentals but also thanks to war chests of FX reserves built up after the crises of the 1990s. FX reserves dipped for most (with the exception of China) but managed to hold off speculation convincingly (see Exhibit 5). Going forward, we expect economies which have seen the success of such self-insurance to rebuild reserves and then allow them to grow in line with the size of the economy or the size of the financial sector after that to maintain their self-insurance capability.

Learning from history, the process of unwinding or reversing imbalances can take a long time (see Exhibit 4). While rebalancing is ongoing, the mix of nominal exchange rate movement and relative inflation movements remains uncertain and can cause serious anxiety for policy-makers in particular, whose domain it is to deal with these macroeconomic indicators. We can quickly grasp why it is only a small step from the global imbalance debate to 'currency war' tensions, as we have recently discovered in practice. If price adjustment via differences in relative inflation is sluggish, then sharp moves in nominal exchange rates can quickly solve the problem, and those impatient for adjustment will lobby for the latter. On the other hand, under fixed exchange rate regimes, all adjustment must fall on prices, which is inflationary for a country moving out of surplus, and deflationary for a country moving out of deficit.

Tensions have abated, like the imbalances themselves, since 2007. But there are no 'immaculate transfers' here and no quick solutions either.

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 Emerging Issues – Global EM Economics
 Current Account Reversals

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