

Box 1

IS THE NARROWING OF GLOBAL IMBALANCES SINCE THE FINANCIAL CRISIS CYCLICAL OR PERMANENT?

Global current account and financial imbalances have narrowed markedly during the financial crisis. From a policy perspective, it is important to determine to what extent this narrowing constitutes a structural feature of the global economy, and to what extent it is cyclical, which would imply a renewed widening of imbalances, thereby putting the global recovery at risk. As well as macroeconomic risks associated with global growth, the re-emergence of widening global imbalances may have negative effects on euro area financial stability through increased market and liquidity risks. In particular, should investor concerns focus on the sustainability of public debt, countries with large deficits may experience funding pressures owing to heightened risk aversion and a concomitant rise in bond yields. This may also have an impact on the term structure of international interest rates and lead to volatility in foreign exchange markets, which could spill over to other market segments. Moreover, if global imbalances were to widen and concerns relating to the condition of countries with large external deficits or surpluses were to arise, the risk of disorderly exchange rate adjustments may emerge. Aside from financial stability considerations, this question is also central to international policy discussions, particularly in the context of the G20 Framework for Strong, Sustainable and Balanced Growth, which aims to ensure a durable reduction in global imbalances, together with a sustained global recovery.

The analysis presented in this box aims to quantify how much of the ongoing evolution in the external positions of the key deficit and surplus economies is cyclical in nature and how much is permanent. A cyclical adjustment implies that the factors underlying the change in current account positions are transitory and relate to the evolution of the business cycle – such as those related to transitory changes in commodity prices, wealth effects or macroeconomic stimulus policies – and are thus likely to reverse over the medium term. An adjustment is considered structural in nature if it is due to more fundamental changes in the economies, such as those related to private savings/investment patterns, demographics or structural policies. This taxonomy of cyclical versus structural adjustment is constructed on the basis of estimates

Estimated cyclical, permanent and unexplained components of the change in selected economies' current account position between 2007 and 2010

(percentage of GDP)

	Permanent	Cyclical	Unexplained
United States	-0.1	0.9	0.9
Euro area	0.1	-0.9	0.1
Japan	0.2	-1.2	-0.3
United Kingdom	-0.7	0.3	0.7
China	-0.6	-4.5	0.5
Oil exporters	-0.7	-3.6	0.0
Emerging Asia (ex. China)	0.0	-1.6	-0.5
Latin America	0.1	-0.9	-0.8
Emerging Europe (CEE3)	-0.2	2.6	1.2

Sources: IMF World Economic Outlook and ECB calculations.

Notes: Based on a Bayesian framework and on 16,000 models spanning all possible combinations of macroeconomic fundamentals for each country. Emerging Asia = Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand; Oil exporters = Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates, Russia and Venezuela; Latin America = Argentina, Brazil, Chile and Mexico; Emerging Europe = Czech Republic, Hungary and Poland.

for equilibrium, or benchmark, current account positions, based on a model developed by ECB staff.¹ In estimating the current account benchmark, all possible combinations of a wide range of macroeconomic and structural fundamentals are taken into account for each country, leading to the estimation of a large number of models. These models are averaged according to their likelihood of being the “true” model of the current account. The (probability-weighted) average of these models provides the estimate of the current account benchmark. Actual current account positions are then compared with the current account benchmarks consistent with underlying macroeconomic and other structural fundamentals in the medium term to obtain estimates of permanent and de-trended temporary/cyclical components. The resulting time-varying trend is thus the unexplained part of the current account, i.e. the part which cannot be explained by fundamentals or by the business cycle.

The results presented in the table focus on the decomposition of the change in the current account positions of selected economies into permanent, cyclical and unexplained components over the period from 2007 to 2010. According to the model, the narrowing of global imbalances during the financial crisis was largely cyclical. The estimates for the main *external deficit economies* suggest that about 50% of the overall adjustment in the US current account between 2007 and 2010 was cyclical (i.e. 0.9 percentage point of GDP out of a total absolute change of 1.9 percentage points of GDP),² as was about one-fifth of the United Kingdom's current account narrowing. The results are more striking for the main *external surplus economies*. About 80% of the adjustment in China's surplus between 2007 and 2010 is estimated to have been cyclical, compared with 70% in the case of Japan. For the oil exporters, the cyclical component accounts for close to 85% of the adjustments. As for the euro area, just over 80% of the deterioration of its current account between 2007 and 2010 is estimated to have been cyclical.

Overall, the results of this model suggest that the narrowing of global imbalances during the financial crisis was largely cyclical. Structural factors underpinning financial and current account balances remain, and along with the growing fiscal pressures in the advanced economies, these

1 See M. Ca' Zorzi, A. Chudik and A. Dieppe, “Current account benchmarks for central and eastern Europe: a desperate search?”, *ECB Working Paper Series*, No 995, January 2009, and M. Bussière, M. Ca' Zorzi, A. Chudik and A. Dieppe, “Methodological advances in the assessment of currency misalignments”, *ECB Working Paper Series*, No 1151, January 2010.

2 The contribution of the cyclical component to the current account adjustments is calculated relative to the absolute sum of the estimated current account components, to take into account the fact that some contribute positively and others negatively to the actual change in the current account.

may cause a resurgence of imbalances in the medium term. While a disorderly unwinding of global imbalances would be particularly concerning, appropriate policy measures can play a role in the resolution of structural imbalances, helping to reduce the downside risks to global growth, as well as the possible negative implications for financial stability.