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Readapting macroeconomic management to a globalized economy: How to handle the accountability on the current account balance

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Abstract: Current account imbalances that have been a component of the globalization process threaten overall macroeconomic management, jeopardize financial stability and exacerbate effects of financial turmoil. Despite its detrimental effects, however, current account imbalances are overlooked by policy makers. In this paper we argue that assigning the responsibility to monitor and be accountable on the current account balance to an appropriate public institution would improve macroeconomic management not only in terms of soothing external balance but would also make internal balance concerns less troublesome and mitigate risks of economic and financial crises. Considering the developments particularly in the aftermath of the global financial crisis, we propose the central bank as a plausible candidate.

Keywords: macroeconomic policy, macroeconomic management, current account, current account sustainability, central banking



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1. Introduction

The primary goal of macroeconomic policy is to maintain internal and external balances.¹ Internal balance refers to maintaining high economic growth, full employment and price stability; external balance refers to maintaining current account (CA) balances. Prior to the 2007/08 global financial crisis (or the Great Recession), developed economies enjoyed two decades of steady real GDP growth and low and stable inflation. The favorable macroeconomic performance during this period that was later named the “Great Moderation” led economists and policy makers to believe that they have now learned how to conduct successful macroeconomic management.² For example, Clarida, Gali and Gertler (2000; 18) argued that better monetary policies resulted in reduced inflation and output volatility during the Great Moderation.

Even after the crisis, while some scholars recommended reconstructing the overall macroeconomic theory, the mainstream approach has been to readapt slightly the prevailing macroeconomic management. Regarding the former, for instance, Stiglitz (2011, 2014) criticizes the mainstream macroeconomic theory that it failed to predict the crisis itself and its full consequences; and it neither provided good guidance to policy makers in responding to crisis. Accordingly, the author suggests a fundamental re-examination of the prevailing models. With respect to the latter, for instance, Blanchard, Dell’ariccia and Mauro (2010) argue that the general policy framework should remain the same since the crisis was not triggered primarily by the macroeconomic policy. The main adjustments that the authors suggest are extending the scope of fiscal policies in regular times and undertaking better financial regulation practices.

Meanwhile, significant progress in financial regulation has already taken place. In particular the Federal Reserve (Fed) and Bank of England (BOE), have, for example, been reframing their structures so as to take more active role in financial regulation. For instance, in April 2013, BOE established an independent Financial Policy Committee as a new independent regulatory body whose primary objective is “identifying, monitoring and taking action to remove or reduce systemic risk with a view to protecting and enhancing resilience of the UK financial system.”³ Moreover, the new governor of BOE, Mark Carney’s “unparalleled expertise in financial regulation” (as expressed by Chancellor of the Exchequer George Osborne) was considered to have played a decisive role on his appointment to the position in July 2013.⁴

In the US, first, the Dodd-Frank act that aims to promote financial stability became effective in 2010. And more recently a team headed by Paul Volcker, a former Fed governor prepared a report towards a more effective financial regulatory system in the US. The report assumes a superior role for the Fed in financial regulation and suggests Fed to be the primary authority in financial sector regulations.⁵

Reframing central bank structures in order to improve financial market supervision will definitely improve macroeconomic management and prevent future financial turmoil. Nevertheless, in dealing with financial market weaknesses policy makers seem to overlook current account deficit. In the recent global financial crisis, as well as in the emerging markets financial crisis in the second half of the 1990s, CA turned out to be a significant macroeconomic imbalance that not only threatens financial stability but also exacerbates effects of financial turmoil.

Supporting this view, Lane and Milesi-Ferretti (2010) investigate pre-crisis macroeconomic and financial factors that explain the severity of the 2007-08 global financial crisis (in terms of economic activity). They find that along with rapid private credit growth, high current account deficits prior to crisis significantly deteriorated growth of domestic demand and (but to a lesser extent) output during the crisis.

Even in the aftermath of the crisis, current account deficit turns out to be crucial in identifying countries’ vulnerabilities. For instance, Rai and Suchanek (2014) estimate the impact of Fed’s tapering practices on emerging market economies’ financial markets and capital flows. The authors find that announcements and implementation of Fed tapering resulted in the depreciation of currencies, fall in stock markets and increase in bond yields; and vulnerable countries (the ones with weaker fundamentals) were somehow more exposed to adverse effects of tapering. The study concludes that, current account balance turns out to be one of the key explanatory variables as an indication of a country’s ability to meet its financing needs; more specifically, spillover effects of Fed’s policies are higher when a country has higher current account deficit.

On the policy makers’ side, current account imbalances was brought up in G20 Seoul Summit Leaders’ Declaration (2010) and the IMF was requested to help develop indicative guidelines for the reduction of global current global imbalances. In response, Blanchard and Milesi-Ferretti (2011) suggest incentives for correcting not only current account deficits but also surpluses.

¹ See, for instance, Carbaugh (2013; 481), Nayyar (2013; 8) or Blanchard, Dell’ariccia and Mauro (2010).

² Blanchard, Dell’ariccia and Mauro, 2010

³ Financial Policy Committee (undated).

⁴ See <http://www.theguardian.com/business/2012/nov/26/mark-carney-bank-of-england-governor> for news on Carney’s appointment as the governor of the BOE.

⁵ See The Volcker Alliance (2015).

The above mentioned studies indicate that current account imbalances are not only a problem of external balance but it also threatens the overall macroeconomic stability and management as it jeopardizes economic growth, employment, price stability and financial stability.

Despite its substance, however, so far no country has developed a comprehensive/ institutional framework incorporating current account imbalances into macroeconomic management. More specifically, in the mainstream macroeconomic management approach, all of the key policy targets and indicators except for current account balance has an accountable responsible: the government overall is held accountable for GDP growth and employment performance in the country; and the central bank is accountable for price stability. There is, however, no policy maker who is held accountable for the current account performance. This, leads to a clear overlook of a key macroeconomic variable until a crises becomes accountable.

In this paper we argue that assigning the responsibility to monitor and be accountable on the current account balance to an appropriate public institution would improve macroeconomic management not only in terms of soothing external balance but would also make internal balance concerns less troublesome and mitigate risks of economic and financial crises.

2. Current account problems in recent history

Concerns about CA balance can be traced back to 16th century Mercantilism which favored trade surpluses for a country to accumulate reserves. As a matter of fact, broadly up until 1980s when international capital flows were meager, balance of payments analysis was, by and large, based on export and import demand relationships where trade deficit was considered as overspending that needs to be adjusted.⁶

Large swings in CA balances in the 1970s (partly as a result of the two oil price shocks) led to a revival in early 1980s of interest among economists and policy makers in CA balance. New approaches to CA balance are developed. In order to explain determinants of current account and exchange rates in the intermediate run, Sachs (1981) expanded the import-export based explanations and integrated the current account approach with modern theories of saving and investment. Aizenman (1983), on the other hand, developed a two-period, two-country model that derives the current account model where agents behave optimally and money is used as a means of exchange.⁷

Crisis in emerging markets in the 1990s again surged concerns about CA balances. Corsetti, Pesenti and Roubini (1999), for instance, argue that financial imbalances, particularly large current account deficits that the Asian countries exhibited during the 1990s exacerbated the 1997 Asian currency crisis. In the same vein, Kaminsky and Reinhart (1999) investigate the fragility of economies around the time of financial crisis. The authors identify the indicators that are linked to CA as percent deviation of real exchange rate from trend, the value of exports and imports and the terms of trade. Indeed, in the early warning system (EWS) literature, which aims at predicting financial crisis, CA to GDP ratio is considered to be a highly informative variable.⁸

While soaring CA deficits were typical for a number of emerging economies during the 1990s, so were the abrupt reversals of CA deficits that are associated with “sudden stops” of capital inflows. Milesi-Ferretti and Razin (1998) study 105 low and middle income countries and they identify four major factors that drive the occurrence of reversals: large current account deficit, overvalued real exchange rate, and unfavorable terms of trade and low foreign exchange reserves. Though it is important to note that elevated CA deficits, followed by reversals induce serious damage on economies as “sudden stops” are often followed by significant economic slowdown and an exchange rate and banking crisis.⁹

In fact, even casual observations of worsening CA balances anticipating sharp reversals may suggest the relevance of CA balance as a key macroeconomic lever as well as financial crises indicator. More specifically, Figure 1 clearly indicates the Mexican peso crisis in 1994, and the 1997 Asian financial crisis. Indonesia, South Korea and Thailand were the three countries that were most severely hit by the Asian crisis. And the sharp reversal in the CA deficit to GDP ratio in these countries makes this point more apparent.

⁶ Sachs (1981; 263)

⁷ For a survey on the intertemporal approach to the current account see Obstfeld (1995).

⁸ See, for instance, Berg and Pattillo (1999).

⁹ Kaminsky and Reinhart (1999) and Edwards (2004). See, also, Calvo and Talvi (2005) for descriptive analysis of sudden stops.

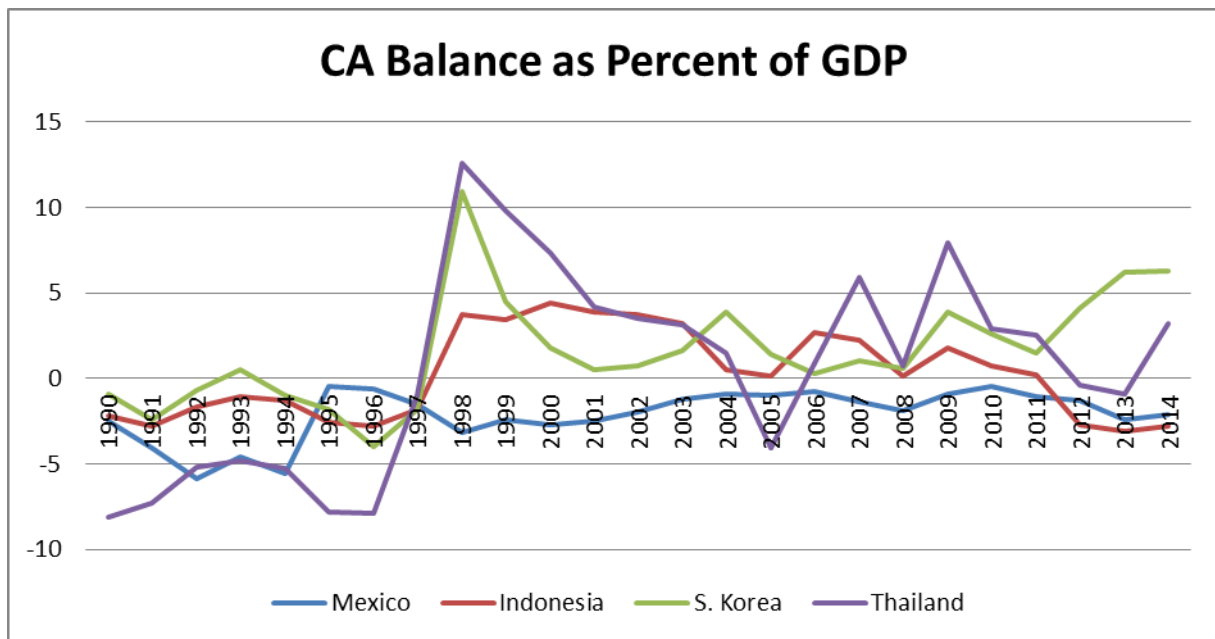


Figure 1. CA balance as percent of GDP, selected countries

Source: Oxford Economics, Global Data Station

CA deficit was not only the problem of developing countries throughout the 1990s. Lane and Milesi-Ferretti (2011) empirically investigate whether the severity of global financial crisis is systematically related to pre-crisis macroeconomic and financial factors. The cross-country results of the study indicate that there is a strong link between pre-crisis domestic financial factors (fast private credit growth) and external imbalances (current account deficits) on the one hand, and the financial crisis (as measured with the growth rate of output and domestic demand) on the other hand. More recently, in Greece, a member of the European Union and the Eurozone the CA deficit peaked to 15 percent of GDP in 2008, just before the country was dragged into the financial and economic crisis of historical proportions.

The link, if not causality between the current account balance and financial crises is not limited to be seen in developing economies. While remained mostly balanced up to 1980s, the CA deficit in the USA reached record levels starting from the late 1990s peaking at 6 percent of GDP just prior to the 2007/8 financial crises. CA deficit tended improve only after the crises (Figure 2) partly due to the slowdown in the domestic consumption.

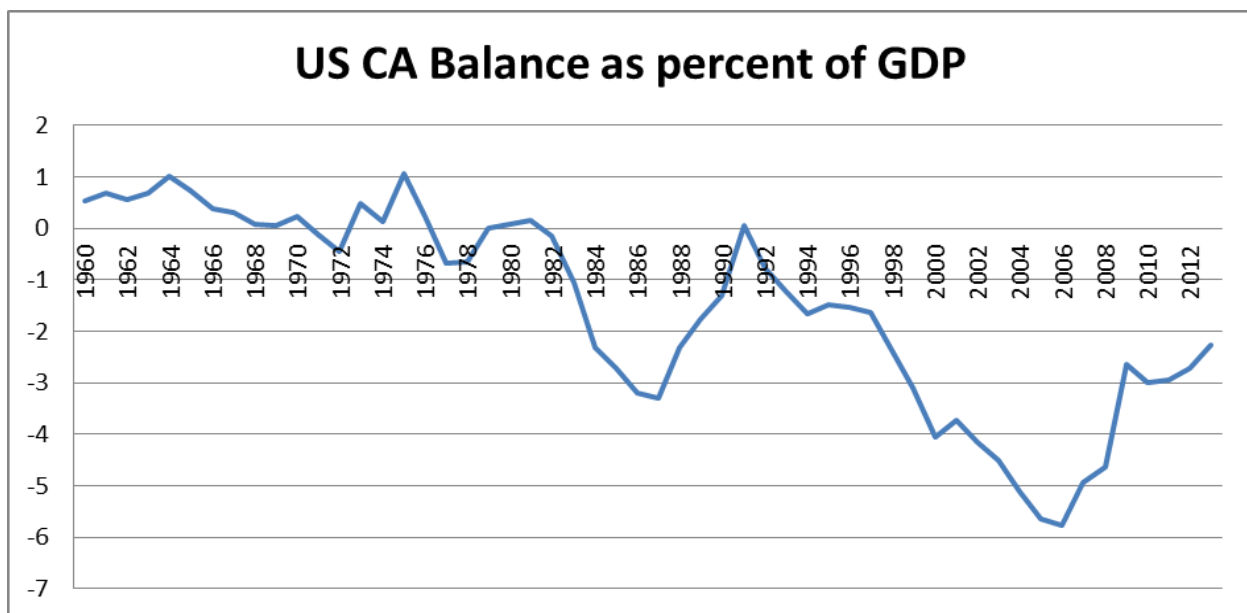


Figure 2. USA: CA Balance (percent of GDP)

Source: OECD

Furthermore, the 'global imbalances' emanating from the US CA deficit and excessive savings and CA surpluses mainly in Asian emerging economies and oil exporting countries are associated with the 2007/08

global financial crisis.¹⁰ Specifically, Bernanke (2005) suggested (the so-called global saving glut hypothesis) that significant increase in savings and decrease in investments in Asian emerging markets during 1996-2006, in the aftermath of the Asian financial crisis, resulted in rapid flow of capital to the USA. In return, US dollar and stock prices appreciated and interest rates and savings declined in the US. As low interest rates encouraged home ownership, elevated house prices encouraged households to increase their consumption. Subsequently, Bernanke (2005) suggested that the US CA balances deteriorated and the US housing market bubble was formed.

Even though the “saving glut” hypothesis is still controversial,¹¹ in the formation of the 2007/08 global financial crisis, CA deficits played a significant role reminiscent of the Asian financial crisis in late 1990s. In accordance with this argument, Obstfeld (2012) argues that current account balances must still be watched by policy makers due to three reasons. First, current account deficits indicate the presence of related problems, such as rapid increase in domestic credit. Second, high current account deficit still calls for the risk of “sudden stop” as suggested by Calvo and Reinhart (2000). And third, current account position, over the long run, tracks the net international investment position of an economy which in essence indicates solvency of a country.

All in all, the behavior of CA deficit throughout time, and the problems it may cause in different countries, independent of the level of development, does not vary significantly. Hence, as in other factors that macroeconomic management monitors, the CA balance should also be monitored and managed by an appropriate governmental institution on an accountability basis.

3. Why CA deficit is overlooked?

If it is such a critical variable, why is the CA balance overlooked in the macroeconomic management framework with no directly accountable decision maker? Maybe because, under growing international liquidity since 2001 and especially after the 2007/8 global financial crises, as long as the deficit financed by international capital inflows, the short term welfare gains generated by the CA deficits has almost no negative side effects.

On the other hand, the general public monitors and cares about key macroeconomic variables which pose additional pressure on the economic managers’ institutionally imposed accountabilities. For instance, by utilizing life satisfaction survey data and running an OLS regression analysis, Di Tella et al. (2001) test how European and US citizens’ level of wellbeing vary with the level of inflation and unemployment. The results suggest that unemployment has a larger weight in a welfare function that is composed of unemployment and inflation.

Similarly, Welsch (2007) analyzes the determinants of life satisfaction among European citizens. When the author considers only inflation and unemployment rates the results suggest that people care more about unemployment than they do for inflation. However, when the model is extended so as to incorporate growth rate and long term interest rates into the regression, it turns out that households care about growth and employment on the one hand, and “stability” on the other hand, where stability is measured by either inflation rate or long term interest rate.

However, while adverse effects of imbalances in other macroeconomic management variables (inflation, unemployment and growth rate) are closely followed by the macroeconomic managers and general public without any benefits; the CA deficit, by allowing domestic economic agents to spend beyond their means, generates ‘borrowed welfare gains.’ In support of this view, intertemporal approach to CA argues that it may be rational for a country to run CA deficit if it drives physical investments that improve productive capacity.¹²

4. Who should be responsible for the CA?

As argued above, the risks emanating from the deterioration of the CA deficit, has shown the potential to spread to jeopardize the internal balance variables as well and to exacerbate the effects of financial crisis.

If it is such a critical variable and if the responsibility of monitoring and ‘managing’ the CA should be relegated to an ‘economic manager,’ who should it be? Probably the central bank for two reasons.

Firstly, under the inflation targeting framework the central banks have one target (inflation rate) and one tool which is the interest rate. However, the interest rate is also the key variable driving international capital flows in and out of the country independent of the level of the trade and thus current account balance. In many actual country experiences including recently, capital inflows have had much higher sizes compared to current account deficits. That led to overvaluation of the local currency despite growing trade and current account deficits. Overvalued currencies, in turn, have led to growing trade (and thus current account) deficits. Thus, central bank policies under inflation targeting have directly influenced current account balance while

¹⁰ Bernanke (2007, 2010).

¹¹ Obstfeld and Rogoff (2009), Taylor (2010) among others argue that the primary reason of the US housing bubble was the excessive loose monetary policy. Borio and Disyatat (2011) argue that even if the global saving glut made some financing available, the main reason of the crisis was the lack of strong anchors in the financial system that prevents unsustainable booms in credit and asset prices.

¹² For a theoretical and empirical analysis of this approach, see Bussiere, Fratzscher and Müller (2004).

concentrating on one target and one tool. That meant while concentrating its only formal tool on its own target, the central banks has worsened another key variable with no accountable responsible. Putting the responsibility of the current account balance under the jurisdiction of the central bank may thus be reasonable, forcing it to 'optimize' targets.

Secondly, while not directly compatible with the roots of the inflation targeting, the central banks have in fact already incorporated a second key target (financial stability). This incorporation is still rather informal as formal incorporation would require the change of the central bank law (the clause on the objectives of the central bank).¹³ However, as we have argued above, there is a very strong link between financial stability and the current account balance. This suggests that, formal or informal, the relegation of the responsibility of monitoring and management of the current account balance would best fit the central bank.

Appendix A. Supplementary material

Supplementary data associated with this article can be found, in the online version, at <http://sepd.tntu.edu.ua/images/stories/pdf/2015/15ymacab.pdf>

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¹³ For example, the Fed and the European Central Bank have launched several QE packages with a view to support financial and economic recovery. The Turkish Central Bank in 2010 announced policies to slow down growth rate of bank credits arguing that rapid credit growth drove the worsening of the current account deficit raising financial stability concerns. See Başçı and Kara (2011) and IMF (2012).

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