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European Commission
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Global Imbalances: False Alarm or Genuine Source of Concern?

By Théo Aphecetche, Maria Bianchi and Guergana Stanoeva

Abstract

Global imbalances, as measured by current account surpluses and deficits, had been on a narrowing path for several years, before widening in 2020 and 2021. While there is nothing wrong per se, excessive current account imbalances, if unaddressed, might pose serious risks to the global economy. These Brief analyses the recent dynamics in global imbalances in the context of the COVID-19 pandemic and discusses the possible effects of the ongoing Russia' war in Ukraine. It notes that while the recent global imbalances widening appears to reflect mostly transitory shocks, uncertainty and downside risks to the global outlook remain exceptionally high. It also underlines that while Emerging Markets Economies' macroeconomic fundamentals appear more resilient to the current monetary tightening, weaknesses remain. The Brief also considers how climate change as a systemic risk could jeopardise the fragile equilibrium of macroeconomic fundamentals. Finally, the Brief presents possible macroeconomic and structural policy options to reduce excess current account imbalances in a growth-friendly manner and to prevent or cushion possible risks.

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Global imbalances: False alarm or genuine source of concern?

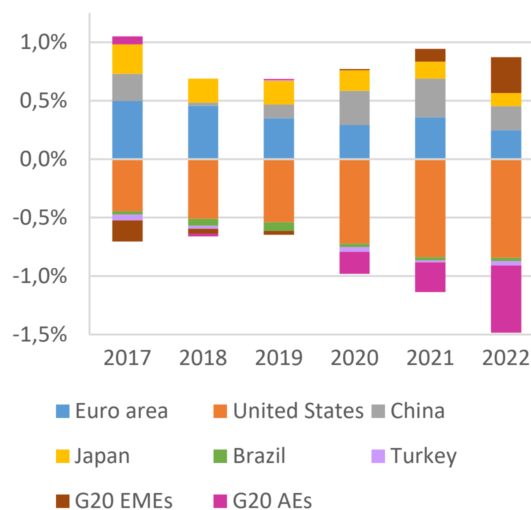
Global imbalances – as measured by current account surpluses and deficits – had been on a narrowing path for several years but widened in 2020 and 2021. While there is nothing wrong *per se* with current account deficits or surpluses, excessive current account imbalances – if unaddressed – might pose serious risks to the global economy. Imbalances can fuel trade tensions and protectionist measures or increase the risk of disruptive currency and capital flow movements.

This Brief analyses the recent widening in global imbalances in the context of the COVID-19 pandemic and discusses the possible effects of the ongoing Russia's war in Ukraine. First, the Brief provides an overall state of play of the current account imbalances in some G20 economies (euro area, US and China). Second, it discusses the underlying drivers of global imbalances in these major economic blocs. Furthermore, many emerging market economies (EMEs) are exiting the COVID-19 crisis more heavily indebted and with more limited fiscal space. The Brief therefore also assesses EMEs vulnerabilities, especially in light of the on-going monetary policy tightening by central banks in advanced economies and in view of climate change challenges. Finally, the Brief presents possible macroeconomic and structural policy options to reduce excess current account imbalances in a growth-friendly manner and to prevent or cushion possible risks. It also emphasises the importance of strengthening global cooperation notably within the G20[1], to tackle excessive imbalances, also considering the role of climate mitigation policies.

Current account imbalances: state of play

Among the major economic blocs, the euro area stands out with a persistent surplus (Graph 1). However, over the last decade, this surplus has not necessarily been excessive as it brought the net international investment position (NIIP) position close to balance. In addition, the economic fundamentals of the euro area suggest that it should be running a surplus, even if slightly lower than the actual outturn[2]. Other large surplus countries include China and Japan. Among the deficit countries, the US stands out as the one with the largest deficit. Overall, large current account imbalances remain concentrated in advanced economies and China.

Graph 1: **Global current account in selected G20 economies (% of global GDP)**



Source: IMF World Economic Outlook, September 2022.

While global current account imbalances had been narrowing for several years, they widened in 2020 and 2021. This recent widening is largely driven by the impact of the COVID-19 pandemic[3]. The channels of transmission include: (i) a decline in trade in services, (ii) a shift in household consumption patterns from services to goods, (iii) an increased demand for medical products, and (iv) a rise in transportation costs[4]. Commodity prices started to rise in the aftermath of the nascent economic recovery, and their increase has been further accentuated by the war in Ukraine.

As the war continues, the outlook for the global economy is turning grimmer, with a significant impact on commodity prices, but also on trade and financial flows. It is too early to have a full quantitative assessment of the impact of the war on global imbalances, but this Brief tries to look at the

[1] G20 has a long track record in dealing with global imbalances, especially in 2010-2011, when they were at record heights.

[2] The European Commission estimates that the current account norm for the euro area would be a surplus of 1.8% of GDP in 2021, compared to an outturn of 2.5% (Coutinho et al. (2018)).

[3] IMF (2022).

[4] Supply bottlenecks hampered smooth and timely flows, while transport costs rose as global demand for tradable goods increased.

effects of some of these channels, notably commodity price pressures.

Recent developments and possible future dynamics in some G20 members

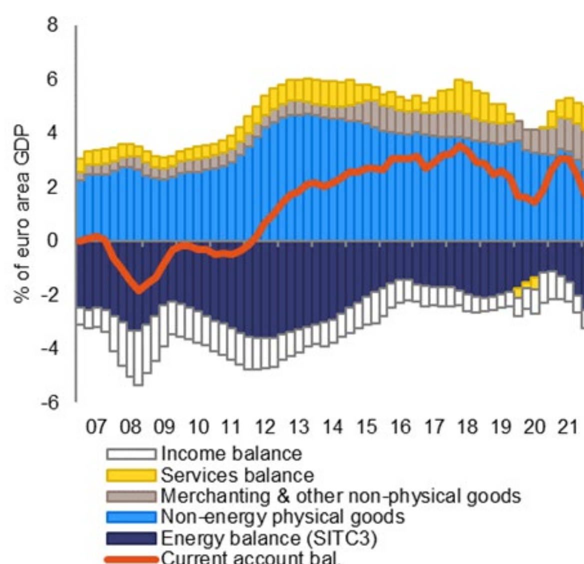
The euro area: a surplus somewhat above the fundamentals

The euro area and the EU have a large positive current account balance. Over the past decade until 2018, the current accounts of both the euro area and the EU rose, reaching surpluses comparable in size to what is observed today. This was mainly driven by a contraction in domestic demand that pushed down imports. The accumulation of considerable surpluses led to improvements in the net international investment positions of the euro area and of the EU, which are now roughly balanced.

As the pandemic kicked in, external accounts worsened in EU Member States dependent on extra EU/euro-area cross-border tourism revenues. In 2020 the overall euro area current account surplus declined due to a lower balance of trade in services, lower factor income balances and a lower balance of trade in goods other than energy (Graph 2). This was only offset in part by a strong positive contribution to the current account that came from the improved balance of trade in energy during 2020, limiting the overall decline. These developments were reversed in 2021, leading to somewhat higher current account surplus, despite a substantial worsening of the energy balance.

The COVID-19 pandemic struck as macroeconomic imbalances in most EU Member States were undergoing a process of correction amid favourable economic conditions, while new risks associated with signs of overheating were emerging mainly at the level of house prices and cost competitiveness[5]. The pandemic interrupted the reduction in debt-to-GDP ratios, while housing prices accelerated. Imbalances related to high government and private debt worsened, driven by the sharp drop in GDP and the unprecedented fiscal stimulus packages implemented to address the COVID-19 crisis. However, the overall current account of the euro area (as a share of GDP) declined only slightly as the expansionary fiscal response to the crisis was roughly matched by increased private savings[6]. In sum, the COVID-19 crisis appears to have only temporarily affected external positions (i.e., surpluses decreased, while deficits increased), but has not fundamentally changed current account patterns in EU Member States. However, high energy prices and worsening energy balances are expected to be important factors in the decline of the euro area's current account surplus going forward.

Graph 2: **Euro area current account (4q moving sum)**



Source: Eurostat.

Indeed, following the start of the war in Ukraine, the further abrupt rise in energy prices – coupled with the considerable share of energy in euro area imports, together with the fact that energy imports are priced mostly in USD – has led to a rise in the value of euro-area imports. Historically, the euro area terms of trade have exhibited a strong negative correlation with energy import prices, as it is their single most important driver. However, the movements at the current juncture appear steeper than in previous episodes, given the sharp increase in energy prices[7].The cost of imports into the EU has surged on the back of the sharp increase in energy prices. This surge was largely attenuated by dynamic growth in export prices, but it is still resulting in an important terms of trade shock. Overall, despite strong export performance, the EU current account surplus is set to shrink significantly[8].

[5] European Commission (2022a).

[6] Similar patterns in developments of individual segments in the balance of payments were recorded for the EU (Graph 2a), but with much weaker overall impact on the current account until this year.

[7] European Central Bank (2022).

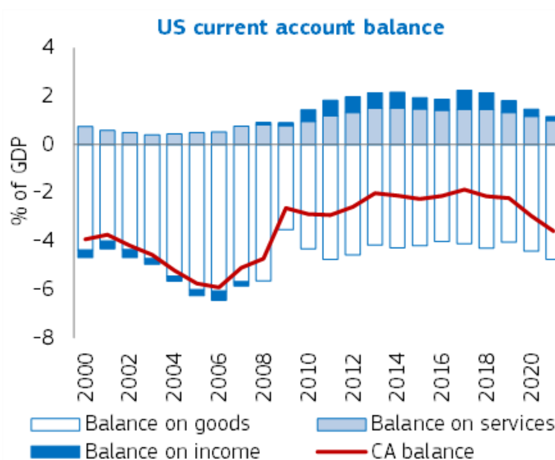
[8] European Commission (2022d).

The US: following its historical deficit path

The US economy has historically run a negative current account balance. Nearly all the US current account deficit is driven by its merchandise trade deficit, with the positive balance of services and primary income offsetting it only to a degree.

The US current account deficit has widened from 2.2% of GDP in 2019 to 2.9% of GDP in 2020 reaching 3.6% of GDP in 2021, following the outbreak of the COVID-19 pandemic and during the incipient economic recovery. This has been mainly driven by a fall in the balance of trade in services but a deterioration in the balances on goods and net income also contributed to it (Graph 3).

Graph 3: **US current account balance**



Sources: IMF BOPS and Bureau of Economic Analysis.

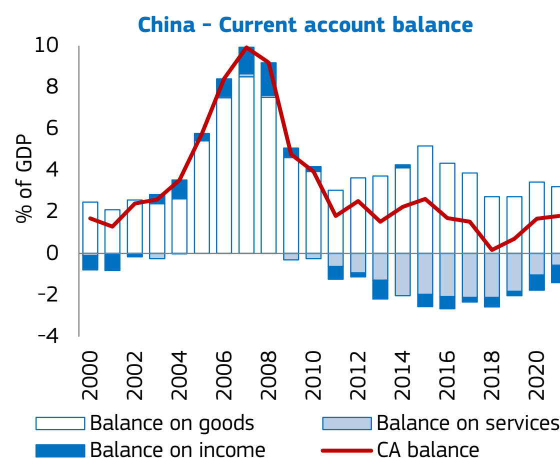
In 2020, the widening of the US current account deficit was accompanied by a large increase in the primary fiscal deficit from 3.5% of GDP in 2019 to 12.4% of GDP in 2020, which was however to a large extent cushioned by an increase in private saving. In 2021, the primary deficit moderated to 8.5% of GDP, again partly offset by a fall in private saving. The overall increase in saving as a share of GDP in 2021 was accompanied by an even stronger rebound in investment.

In the US, as in the euro area, the COVID-19 pandemic has not fundamentally changed the current account pattern. Furthermore, the trade deficit in the first half of 2022 remained larger than in the same period last year. Unless a deceleration of import growth takes place, the 2022 trade deficit is likely to continue the widening trend observed over 2020-2021. Furthermore, the US dollar has appreciated sharply since mid-2021, driven by a switch to "risk-off" behaviour by international investors as well as the ongoing normalisation of US monetary policy putting further pressure in the direction of a current account deficit increase.

China: in line with its well-established surplus feature

China has historically run a persistent current account surplus. In 2021, as the COVID-19 pandemic continued, the trade surplus for goods reached 3.2% of GDP, thanks to robust external demand for goods, broadly related to the pandemic, including medical equipment, electronics, and furniture (Graph 4). The trade surplus was driven by strong overseas demand for Chinese goods, while a drop in outbound travel reflecting the country's harsh COVID-19 rules limited the deficit in services trade. An expanding trade surplus and surging portfolio capital inflows led to a strong rise in the Renminbi.

Graph 4: **China current account balance**



Source: National Bureau of Statistics of China and IMF.

In 2022, circumstances changed. First, Chinese exports have been struggling following the negative impact of the zero-COVID policy on activity in the export sector and the transition of demand from goods to services in many of China's trade partners. Second, portfolio capital outflows accelerated sharply (with a record of USD -79.2 billion in March 2022) as investors' assessment of risk in Chinese markets deteriorated and the divergence in monetary policy between China and the US[9] and the euro area

[9] A pursue of monetary easing by the People's Bank of China opposed to the monetary tightening by the US Federal Reserve and ECB.

widened. In this context, the exchange rate of the RMB against the USD has depreciated.

The war in Ukraine has so far had a limited impact on China's current account surplus. The jump in energy prices should have a negative effect on the surplus, as China is a large energy importer. However, China should be able to take advantage of discounted Russian oil picking up some of the flows no longer going to the EU, but we can expect China to limit the increase of Russian oil in its energy mix in accordance with its diversification strategy.

Overall, China's current account surplus is expected to experience a muted increase. However, it is unlikely to revisit the sizeable surpluses of the late 2000s. in view of an expected structural slowdown in the country's growth path and potential lower absorption of the rest of the world. Furthermore, as the growth rate of China's population will continue to decline, and as the "working-age population" will further decline, China could only sustain its economic growth by reversing the slow-down of productivity growth, which appears unlikely in the absence of a significant change in economic policies. As services are likely to experience a growing share of Chinese total economic activity, the current Chinese regulatory crackdown on important parts of the services sectors, may well reduce the pace of innovation of the services sectors, and eventually its productivity growth.

Emerging Market Economies in the fallout of the pandemic[10]

Decisive and timely policy action allowed EMEs to weather the pandemic successfully

In the fall out from the global financial crisis, EMEs have managed to reduce external vulnerabilities by: (i) limiting their current account deficits, (ii) fostering a real appreciation (iii) reducing their dependency on portfolio capital inflows, and (iv) addressing – where possible – their external financing needs[11]. However, the COVID-19 pandemic has hit them just as they were trying to strengthen their external economic and financial positions. An important channel was the decrease in tourist revenues. Given the importance of the tourism sector for many EMEs, some put forward initiatives to revive it, including through the promotion of domestic tourism (as lockdowns largely affected international travel) and the transformation of the tourism industry into a sustainable industry. Another channel was the role of remittances flows, which proved to be strongly resilient during the COVID-19 pandemic, underscoring its role as an important automatic stabilizer[12].

Overall, EMEs were able to fight off a deeper impact of the COVID-19 pandemic on their economies thanks to the deployment of measures to stem capital outflows and to mitigate the pressures in local currency bond markets. These include: (i) standard crisis management tools, such as foreign exchange interventions and central bank liquidity support in both domestic and foreign currencies, and (ii) large-scale asset purchases by central banks to mitigate stress in local currency debt markets. EMEs adopted quantitative easing measures for the first time[13]. Furthermore, the shifting from informal to formal remittances channels due to travel restrictions appeared to have played a role in the surge in formal remittances, helping many EMEs to fight off a stronger impact of the pandemic[14].

It is important to note that multilateral cooperation supported the decisive actions undertaken by EMEs. Both EMEs and advanced economies' governments acted quickly to counter the negative impacts of the COVID-19 pandemic, by putting in place large-scale fiscal packages that had positive spillover effects to EMEs. In terms of the overall size of the fiscal stimulus, more than two-thirds of governments across the world scaled up their fiscal support after April 2020 to mitigate the economic fallout from the pandemic[15]. Announced fiscal measures have been estimated to be about USD 17 trillion globally, more than doubling the amount of USD 8 trillion in April 2020.[16].

In advanced economies, monetary policy went far beyond standard quantitative easing measures[17]. On

[10] This paragraph describes the situation in EMEs excluding China.

[11] FSB (2022).

[12] IMF (2021a).

[13] Eichengreen et al (2022).

[14] IMF (2021a).

[15] Ibid.

[16] The overall fiscal support provided to the economy by G20 members was more than 18% of their GDP, corresponding to about USD 16 trillion (Granelli, L. et al (2022)).

[17] The fiscal response to the COVID-19 pandemic was massive and sustained, reflecting the view that fiscal support

that front, advanced economies' authorities played a key role in mitigating strains in financial markets globally and helped to ease some of the pressures faced by EMEs. There were indeed positive spillovers from measures directed at advanced economies' financial systems (e.g., asset purchases, liquidity operations and backstop facilities), which helped to restore investor confidence. In addition, some measures (e.g., USD liquidity swap lines and the US Federal Reserve's Foreign and International Monetary Authorities (FIMA) Repo Facility) were more targeted at addressing global USD funding pressures, including those in EMEs[18]. It is important to stress that eligible EMEs also benefitted from the IMF's Rapid Financing Instrument and from a significant additional Special Drawing Rights allocation.

EMEs so far have been resilient but vulnerabilities remain

There is a consensus that EMEs have now stronger monetary policy frameworks than ever before. Central banks in those countries have built anti-inflationary credibility which needs to be preserved as it allows them to be more flexibile and cut rates in difficult times[19]. Current account balances as share of GDP in EMEs are also now smaller relative to GDP than in 2010 although there are some exceptions (e.g., Indonesia, Colombia, Malaysia). Overall, external positions have strengthened, except in some EMEs (e.g., Colombia, Argentina, Turkey and Malaysia), where financing needs are significantly higher than in 2010-2012). With the on-going aggressive increase in US interest rates, some of these countries could find it difficult to attract foreign finance on the requisite scale. A significant fraction of governments' debt, in many national cases, is indeed still sold to foreign investors, who might seek to rebalance away from emerging markets as interest rates begin to rise in the US and other advanced economies. In any case, when external financing turns scarce, countries can resort to foreign reserves as buffer. In this regard, it is encouraging to note that reserve adequacy has improved nearly everywhere. However, Turkey and Argentina are two cases where reserves are inadequate to finance the current account plus maturing short-term external debt.[20] Apart from debt-related issues, monetary policy tightening in advanced economies and a rising USD could destabilise EMEs financial markets, by inducing capital market outflows. Finally, the commodity price jump following the outbreak of the war in Ukraine, leaves commodity importers exposed, in some cases threatening their food and energy security. Further dislocation of supply chains and worsening global economic sentiment are among the other major challenges these economies are facing. All this could worsen their external positions significantly and contribute to a renewed increase in global imbalances.

Looking ahead: Risk factors and the role of climate mitigation policies

The evolution of global current account balances is subjected to extremely high level of uncertainty and the downside risks to the economic outlook could further exacerbate these. These risks include: (i) a prolonged war in Ukraine that could contribute to maintain commodity prices high (including food), and widen global current account imbalances with energy exporters running large surpluses, (ii) a wider geopolitical fragmentation at the international level that could continue to exacerbate global supply disruptions and trade tensions, (iii) a worsening of China's growth slowdown that could negatively affect commodity markets as well as major trading partners (US, EU), (iv) a resurgence of COVID-19 pandemic with ensuing increased fiscal support and further disruption of global supply chains, and (v) financial tightening by advanced economies, leaving the risks open for disruptive capital outflows from

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was withdrawn prematurely after the global financial crisis, fiscal support was prematurely withdrawn hampering the economic recovery. With hindsight, however, it is questionable whether the pandemic fiscal support achieved all its objectives. When provided in the form of either income or employment support, it cushioned the negative impact on disposable income. However, impact on consumption was more limited, due to the necessary containment measures, as such consumer spending did not increase as expected. Evidence shows that in 2020, the stock of household savings accumulated across five large advanced economies (Australia, Canada, Japan, the United Kingdom and the United States) in excess of historical values amounted to an average of 6.7 % of GDP and 9.5% of disposable income, In addition, the savings accumulated during the pandemic have mostly accrued to high-income households, who have a lower marginal propensity to spend out of income or wealth compared with low-income households (Grazia and all, 2021).

[18] FSB (2022).

[19] The ability of a country to weather the possible negative impact of the announcement of taper by advanced economies, includes prior financial conditions (capital inflows, real appreciations in the pre-taper period), and the size of the financial markets.

[20] Eichengreen et al. (2022).

emerging markets, depreciations of their currencies, and a higher probability of default[21].

Furthermore, and with a more medium-term perspective, climate change is the biggest systemic risk facing the world economy, financial systems, and societies today. Its impact on the economy is increasingly visible and may jeopardise the already fragile equilibrium of current account fundamentals. EMEs are notably more directly exposed to extreme adverse climate events. To tackle climate change, countries should engage in climate mitigation and adaptation efforts that will induce major economic transformations. Comparable past episodes of energy transitions, such as oil discoveries, have led to large external sector adjustments in the affected economies. As there are significant structural differences across countries, including the degree of fossil fuel dependence, and the role of renewables in energy provision, the impact of mitigation policies and thereby the impact on the current account balances would vary. Differences in the content and pace of implementation of mitigation policies – following a lack of coordination at global level, both in terms of scope and ambition, but also taking into account the different starting points of countries – are another source of cross-country asymmetries that could make imbalances (re)emerge. In this regard, the IMF has analysed the impact of *the net-zero emission by 2050 scenario* on current account balances[22]. According to the IMF, a credible and globally coordinated carbon tax would generate additional revenue in greener advanced economies, positively impacting their current account balances (i.e., increase surpluses or decrease deficits). As well, it would create additional expenditure in more fossil-fuel-dependent regions negatively affecting their current account balance (i.e., decreasing surpluses or increasing deficits), reflecting disproportionate declines in investment, output and employment in response to the carbon tax in those countries. However, to deliver on the Paris Agreement, it is crucial that the most advanced jurisdictions pave the way to decarbonisation and support less advanced jurisdictions in engaging into ambitious and effective mitigation policies. Coordinated approaches to climate mitigation and adaptation will help avoid an exacerbation of global imbalances.

Policy response: the need for a cooperative approach

Policy responses to promote external rebalancing differ with positions and needs of individual economies, and they should ideally consider spillovers. The war in Ukraine has exacerbated existing trade-offs for policy makers, including between fighting inflation and safeguarding economic growth, and between providing support to those affected and rebuilding fiscal buffers. It is critical that policies to address fallouts from the COVID-19 pandemic and the war are balanced, temporary and targeted, with the need to fight high inflation and rebuild fiscal buffers while prioritising fiscal spending to protect the most vulnerable as long as the exceptional economic conditions last. Policies should also enhance external stability and facilitate external rebalancing. Ultimately, a combination of cyclical factors, domestic policies, fundamentals and spillovers from abroad determines the current account imbalances evolution, and in turn the adequate policy response.

Furthermore, growing imbalances may accelerate the trend towards global fragmentation and fuel the rise of protectionism. Evidence suggests that both bilateral and multilateral trade imbalances are robust predictors of protectionist countermeasures[23]. Moreover, a wider deterioration in the geopolitical environment would further exacerbate trade tensions and supply disruptions globally. In the context of already-rising trade restrictions, this could result in trade fragmentation, for example with the creation of new trade blocs based on near or *friendshoring*[24]. The need to adjust to new trade blocs would add stress to already-strained supply chains and may fuel further protectionism. Thus, rising imbalances could exacerbate protectionist tendencies which in turn could lead to even larger imbalances, creating a vicious circle.

There is no silver bullet policy to address global imbalances. Nevertheless, carefully calibrated macroeconomic and structural policies tailored to specific country circumstances would be needed to

[21] IMF added to the above-mentioned risk the one of a slower than expected recovery in public saving, especially in current account deficit economies. However, we consider that this risk exists even for a constant level of public saving if public investment outpaces it.

[22] IMF (2022).

[23] The quantitative impact of trade imbalances on the rise of protectionism would be sizable for G20 countries: an increase of one standard deviation of the bilateral trade balance between two countries corresponds to a 7.3% increase in protectionist intervention between the two countries. A deterioration of one standard deviation of the multilateral trade balance of a country leads to a 16.6% increase in the protectionist countermeasures of this country. - Delpeuch et al (2021).

[24] IMF (2022).

support growth and mitigate risks to the outlook arising from excessive imbalances. In this regard, the international community, notably the G20, as the premier forum for international economic and financial cooperation - has a role to play in having a clear understanding of how current global economic events and new policy priorities could affect global imbalances going forward; and how to deal with these imbalances.

From a macroeconomic angle, countries with excessive current account surpluses should use available fiscal space to stimulate domestic demand and encourage business investment to boost potential output, especially as monetary policies tighten. For countries with excessive current account deficits, growth-friendly fiscal consolidation will be critical to support external rebalancing and bring the current account balance closer to its fundamentals. However, fiscal consolidation should be implemented in a way that prevents long-term scarring from the pandemic, including by protecting spending for infrastructure, healthcare and education[25]. Temporary targeted policies should help the most vulnerable households and businesses cope with the impact of rising energy[26] and food prices. In this regard, it would be preferable to target measures at supporting the income rather than directly lowering prices.

As regard structural reforms, excess surplus countries should move forward with reforms that encourage high quality public and private investment and discourage excessive private precautionary saving, for instance by widening the coverage of social safety net (e.g., in some emerging markets), reducing labour tax wedge, or tackling informality. Policies should also aim at improving medium-term growth, including through greater public investment in digitalisation, upgrading infrastructure, and climate change mitigation. Excess deficit countries should purse reforms to strengthen competitiveness - including enhancing education outcomes and innovation, and strengthening the skill base of workers, while encouraging saving by adjusting pension schemes and advancing financial deepening.

As regards EMEs, given the highly volatile international environment, it appears urgent to implement additional measures to reduce vulnerabilities stemming from external funding. So far, the development of local currency debt markets has helped to reduce sovereign currency mismatches, but these markets also experienced stress, at least in part due to the withdrawal of foreign investors. This suggests the need to further deepen local currency debt markets and foster a broader domestic investor base. Priority could also be given to developing markets for hedging foreign exposure at the domestic and regional levels to manage currency risks[27].

In view of the possible trade tensions linked to a wider deterioration in the geopolitical environment, ensuring and guaranteeing “fair” trade appear of the utmost importance. Contain risks of trade policies that distort a level playing field would support efforts to reduce domestic imbalances, while supporting growth. Coordinated policy efforts are needed to counter the risks of global economic fragmentation, including by eschewing unjustified barriers to trade. Furthermore, maintaining liquidity in the global financial system will help economies manage risks related to the tightening of global financial conditions, and financial system fragmentation.

Finally, and with a more medium-term perspective, a coordinated implementation of climate mitigation and adaptation policies – with due consideration of the disproportionate economic costs on developing economies – will be critical to address climate change while supporting external rebalancing[28]. Ensuring the participation of all economies to climate related policies is essential and should be facilitated by advanced economies. In this regard, advanced economies would play a key role to support not only the most vulnerable groups *within* countries, but also *among* countries. Advanced economies could also consider to: (i) help the pace of investment in renewables in developing economies, (ii) support countries’ economic diversification and reconversion, and (iii) provide technical assistance to allow EMEs to design the most effective climate policy mix tailored to their country specifics.

Conclusion

Global imbalances increased in 2020 and 2021, and they are projected to further widen in 2022. It is expected that, over the medium term, they would resume their pre-pandemic downward trend, as the impact of the pandemic fades away and commodity

[25] Ibid.

[26] European Commission (2022b).

[27] FSB (2022).

[28] IMF (2022).

prices normalise. Therefore, the recent widening of global imbalances appears to reflect mostly transitory shocks. However, uncertainty and downside risks to the global outlook remain exceptionally high which warrants a renewed focus on global imbalances. This is especially relevant for some EMEs facing possible debt sustainability issues, and for all economies in light of the war in Ukraine and pressing climate-related challenges. A disorderly green transition may add further pressure on current account imbalances, creating additional expenditure in more fossil-fuel-dependent regions negatively affecting their current account balances (i.e., decreasing surpluses or increasing deficits). Multilateral cooperation - G20 is well placed to lead in this regard - will be needed to counter the risks generated by excessive imbalances. As it is an issue of common concern, addressing global imbalances should continue to be at the core of the international discussion going forward.

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