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Global Imbalances and the Implications for Africa

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As indicated by D'Arista and Griffith-Jones (2006), the United States has for most of the past twenty five years carried current account deficits. In large part, the deficit has been sustained by a gradual depreciation of the US dollar vis-à-vis other major currencies, high growth rates in other parts of the world, and a willingness of non-US residents to increase their holdings of US dollars. The phenomenon of large and growing current account deficits of the United States (amounting to \$869.1 billion in 2006, or 6.5 percent of GDP) and the associated large positions that foreigners (especially emerging economies) are amassing in US securities have become a central feature of the global economy, particularly in recent years. It has predictably garnered much attention from the financial press, policymakers, practitioners and, of course, academics. The three chapters by Barry Eichengreen and Yung Chul Park (2006), Jane D'Arista and Stephany Griffith-Jones (2006) and Fan Gang (2006) in the previous volume¹ present an excellent discussion of many of the key issues and the way forward. My comments highlight some key issues to stimulate further discussion and then dwell briefly on the neglected region in the discourse – Africa.

¹ *Global Imbalances and the US Debt Problem: Should Developing Countries Continue to Support the US Dollar?*, edited by Jan Joost Teunissen and Age Akkerman, FONDAD, The Hague, 2006.

1 Why Worry About the Global Imbalances?

Some authors dispute that the large and rising current account deficit of the US is a cause for concern on both historical and conceptual grounds (see, for example, Cooper, 2005; Hausmann and Sturzenegger, 2005), culminating in what Summers (2006) calls “commentaries of the complacent”. According to Cooper (2005), the argument that the US current account deficit is unsustainable is highly questionable and he goes ahead to demonstrate that Americans save quite enough for future generations such that the startlingly large US current account deficit is not only sustainable but a natural feature of today’s highly globalised economy. Thus, a revaluation of the Chinese currency, far from alleviating global imbalances, would run the risk of precipitating a financial crisis.

Indeed Eichengreen and Park point to the merits of a huge current account deficit. It helps sustain growth and redistribute income in the rest of the world. Through trade flows between the US and the rest of the world, the US provides buoyant markets to the exports of the rest of the world and supports the accumulation of reserves by the exporting countries. The latter in particular has provided a cushion to the countries especially in Asia against currency crises. The savings of the exporting countries are recycled back to the US to finance the current account deficits through international capital markets. This process in itself is a source of comfort to some believing that the depth and flexibility in capital markets will be a source of an orderly adjustment to sustainable levels. They refer to it as global co-independence.

Also, Cavallo and Tille (2006) show how the adjustment of bringing the current account down to a more sustainable level would be affected by the high degree of financial integration across countries. The main consequence of financial integration is the growing relevance of valuation effects, where exchange rate movements lead to sizeable changes in the value of a country’s assets and liabilities. They consider an adjustment scenario where current account imbalances are re-absorbed, and the net asset positions of the various countries are kept constant. Their main finding is that high financial integration can potentially generate a “smooth landing” pattern, with a very gradual movement of the current accounts into balance.

However, according to Summers (2006), while arguments about “financial dark matter” or the US ability to issue debt in its own currency probably have some force in thinking about what level of external debt is sustainable for the US, they clearly do not make the case for indefinite

continued expansion of debt.

In addition, available evidence shows that the current state is different from previous global experiences. Indeed, the US current account deficit has been unusually high now for a long period, going from a current account surplus of 0.7 percent of GDP in 1991 to a current account deficit of 6.5 percent of GDP in 2006. Also, the US current account deficit is financing consumption rather than investment as the US net national savings rate is now at a record low level of under 2 percent. Moreover, investment is tilted towards real estate and the non-traded goods sector rather than the traded goods sector and away from exportables. Finally, the net flow of direct investment is out of the US and the flow of incoming capital appears to be of shortening maturity and coming increasingly from official rather than private sources (Summers, 2006).

Moreover, there are serious concerns about how the unwinding of global financial imbalances might affect the external financing conditions in which emerging market economies operate. The greatest risk would arise from an abrupt and disorderly adjustment of major exchange rates, combined with a higher-than-expected rise in international interest rates. Indeed, persistent structural weaknesses in banking and financial systems, particularly combined with high indebtedness or a record of macroeconomic mismanagement and default, render some low-income and struggling economies especially vulnerable to sudden reassessments of country risk by capital markets. In addition, a sharp depreciation of the dollar might lead to large capital losses in local-currency terms for developing economies with substantial dollar reserves though those with dollar-denominated debt would benefit from the erosion in the dollar value of their debt. In sum, the large US current account deficit is unsustainable in the long run (see Rajan, 2006).

The three chapters by Eichengreen *et al.* (2006), D'Arista *et al.* (2006) and Fan (2006) do warn of a real danger of a disorderly correction of the US current account with potentially devastating macroeconomic implications for the developing countries through both the trade and financial channels. Indeed, the US dollar will not be able to play the role of reserve currency and anchor that stabilises the global currency markets. D'Arista *et al.* (2006) reveal weaknesses in the global international financial system that would be expected to respond to such a crisis. In their view, the IMF may not be able to marshal and coordinate the necessary international response to such a crisis. This then calls for innovative corrective actions at the level of individual or a group of countries.

2 Global Adjustment Scenarios

Barry Eichengreen and Yung Chul Park identify a number of global adjustment scenarios by discussing the actions different country groups and economies could undertake. These can be categorised into three: the benign, disorderly, and coordinated adjustment scenarios.

The benign scenario is one in which the phasing out of the factors which caused the imbalances leads to a gradual and orderly adjustment. In essence, this scenario primarily involves an increase in savings in the United States, to levels that are compatible with the long-term rate of investment. The resulting slowdown in consumption would have a moderating effect on imports, thus gradually reducing the external deficit. However, this scenario could occur, in particular, if real estate prices were to stabilise, thereby moderating household indebtedness, which in recent years had grown very fast.

The disorderly adjustment, mainly led by financial markets, occurs due to doubts regarding the sustainability of the situation, resulting in abrupt changes in the prices of financial assets with serious adverse implications for corporate bodies, banks, households in both the US and emerging economies. In the third scenario, the adjustment is supported by coordinated economic policies, taking into account both domestic and external requirements.

Unfortunately, divisions appear to deepen over the global imbalances (Rowley, 2006) as exemplified by positions canvassed during the Asian Development Bank's 2006 Annual Meetings. While the US argues that there is still scope for orderly changes given that it is a general equilibrium problem that will require a general equilibrium solution, China cautions that the appreciation of the renminbi demanded by the US threatens to cause an implosion in the economy which is rapidly becoming the main driver of global growth. On the other hand, the Japanese observe that over-reliance on exchange rate adjustments could deal a blow to global markets, insisting that imbalances have to be addressed through "structural adjustment" in the real economy. Germany, on its part, warned that the possibility of a disorderly unwinding of global imbalances is by no means zero, thus raising the "chilling prospect" that a falling dollar could trigger a wave of global trade protectionism. Indeed, what are needed now are not discordant tunes but a coordinated global strategy to address the global imbalances. Such a coordinated approach would encourage the adjustment of imbalances and allow the global economy to grow in a sustainable manner.

D'Arista *et al.* (2006) explore two counter-cyclical instruments that individual developing countries could introduce as mitigating measures. The first is the GDP-linked bonds that would pay an interest coupon based on the issuing countries growth rate. Payments would be smaller in periods of lower growth. This would have the advantage of cushioning fiscal expenditures during periods of slower growth. The attractiveness of this proposal especially for developing countries lies in the fiscal flexibility that is introduced in fiscal management. In periods of high growth especially associated with commodity booms, the budget would be protected from unsustainable fiscal expansion. Contrary, a country would not be forced into social sector cuts during a period of slower growth. An added beauty of this instrument is the reduction in the risk of default. D'Arista *et al.* call on international financial institutions (IFIs) to consider issuing GDP-indexed bonds. The authors also call on IFIs to consider introducing explicit counter-cyclical guarantees that would be used as private lenders scale back exposure to emerging markets. I find these proposals appealing and think that they should be subjected to a serious evaluation with a view to implementation.

The second instrument is the issuance of local currency bonds. This would facilitate borrowing by a country in local currency and cushion it against currency mismatch. A number of IFIs are exploring ways of increasing issuance of local currency bonds. The African Development Bank has issued Naira and Cedi bonds and intends to explore further issuance in 2007.

In this volume, Jane D'Arista proposes a reform of the international payment system by setting up a clearing house system. Similar systems were proposed and set up to facilitate payments in the regional economic blocs. Given that most of these systems were based on the control model for foreign exchange, liberalisation of foreign exchange markets rendered them inoperative. The proposal, if it is to succeed, must be consistent with the policy environment in a country and should be efficient in its operations. Otherwise the private sector will shun it.

3 Where is Africa in All These?

The global imbalances effects, adjustment, approaches and recommendations in the two studies by Barry Eichengreen *et al.* (2006) and D'Arista *et al.* (2006) totally ignored assessing implications for Africa.

Table 1 Current Account Balance of Africa and Developing Asia, 2005

(in billions of dollars and percentages)

	amount	percentage of GDP
Africa		
Nigeria	12.3	12.4
Algeria	21.7	21.3
South Africa	-10.1	-4.2
Rest of Africa	-5.5	-1.5
Total Africa	18.4	2.3
9 surplus countries	43.2	
41 deficit countries	-24.8	
Developing Asia		
China	160.8	7.2
Malaysia	19.9	15.2
Rest of Developing Asia	-10.1	-0.6
Total Developing Asia (26 countries)*	170.6	4.2
11 surplus countries	190.3	
15 deficit countries	-19.7	

Note:

* The 26 countries of developing Asia are: Afghanistan, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, China, Fiji, India, Indonesia, Kiribati, Lao, Malaysia, Maldives, Myanmar, Nepal, Pakistan, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Thailand, Timor-Leste, Tonga, Vanuatu, Vietnam.

Source: Calculated from IMF, 2006.

Does it mean that Africa is insulated from the adverse effects of any disorderly unwinding of the US deficit? In what follows, I attempt to examine what has happened in Africa, especially in relation to the conclusions of the two studies relating to emerging economies.

A large share of Africa's exports is priced in dollars in the international markets while the imports are largely valued in euros. Any significant depreciation of the US dollar would be a source of a double whammy on African countries. Export earnings would be reduced in relative value while imports would be more expensive widening the current account in absence of contractionary policies. Associated with the above, most of the reserves are held in dollars in spite of efforts to

diversify holdings. Any depreciation in the US dollar would expose Africa to revaluation losses. Indeed, most of the African countries have limited room for reserves diversification. Many central banks match the composition of reserve currencies to the foreign liabilities. Given that most of the foreign liabilities are denominated in dollars or SDR, the space for diversification is very limited.

As shown in Table 1, Africa as a whole had in 2005 a small current account surplus of \$18.4 billion, while Developing Asia had a surplus of \$170.6 billion (IMF, 2006). However, in Developing Asia, China is responsible for almost the entire surplus, while Malaysia has a big surplus too (over 15 percent of GDP). If China and Malaysia are excluded, the total surplus of Developing Asia (4.3 percent of GDP) turns into a deficit (-0.6 percent). Of the 26 countries in Developing Asia, 16 had a deficit in 2006, up from 10 countries in 2003.

Of the 50 African countries, in 2005, 41 countries had a current account deficit, while 9 had a surplus; other recent years show a similar pattern. Algeria, Nigeria and South Africa dominate the picture, because their GDP together is \$366.5 billion, which is almost half of Africa's total GDP of \$807.1 billion. In 2005, Algeria and Nigeria had big current account surpluses (respectively 21.3 and 12.4 percent) because of their oil export, while South Africa had a big deficit (-4.2 percent). For all African countries together, the current account surplus was \$18.4 billion, which is 2.3 percent of total GDP. Excluding Algeria, Nigeria and South Africa, this surplus turns into a deficit of \$5.5 billion, which is -1.5 percent of total GDP of these 47 countries.

In comments by Henk Brouwer on the chapter by Jane D'Arista included in this volume, he refers to current account deficits of developing countries as evidence to counter the claim that capital is unfairly flowing from "poor" economies to "rich" nations. This observation is correct as sub-Saharan African countries sustain these deficits through either private flows including remittances and Overseas Development Assistance. Such flows would represent the recycling of flows back to developing nations. However, a word of caution is in order. There is a disproportionate distribution of these flows back to Africa. The donor countries and multilateral banks use performance-based allocations that favour the "good performers". These countries are also the ones most favoured by private flows. There remains a challenge of directing flows to "poor performers" or countries under stress.

A similar pattern as that of current account deficits emerges for external reserves. In 2005, Africa's external reserves stood at \$168.9 billion while

Table 2 External Debt of Africa and Developing Asia, 2005
(in billions of dollars and percentages)

Debt Category	Africa	Developing Asia
Billions of dollars		
External Debt	289.4	808.3
Debt Service	34.3	107.5
Share of Exports		
External Debt	92.4	53.3
Debt Service	10.9	7.1

Source: IMF (2006).

that of developing Asia was \$1,167.5 billion or about seven times that of Africa. China accounts for over 70 percent of Developing Asia's reserves (\$822.6 billion). Nigeria and South Africa account for 77 percent of Africa's reserves, leaving only \$38.9 billion for the rest of Africa. Again, there is a very significant difference in reserves in favour of Developing Asia.

Table 2 shows that Africa's external debt outstanding stood at \$289.4 billion in 2005 compared to \$808.3 billion for Asia, representing 92.4 and 53.3 percent of exports, respectively. Debt service as percentage of exports stood at 10.9 percent in Africa in 2005 compared to 7.1 percent in Developing Asia during the same year. The above figures clearly reveal that Africa in a large part lacks an effective cushion in foreign exchange reserves cover to resist an international financial crisis.

Africa is more integrated into the global trading environment than into the international financial markets. Commodity exports account for a large share of their merchandise exports and in a large measure determine the variability in the current account position, foreign exchange reserves build-up, and the government's fiscal performance. Many of the countries depend on three or even fewer commodities for most of their export earning. This makes Africa very vulnerable to volatility and downward movements in prices. In the past three years or so, a number of oil- and metal-exporting countries have recorded very impressive growth rates and current account surpluses due the high oil and metal prices. In Africa, adequate commodity risk management is a bigger development challenge than adequate financial crisis management.

A steep rise in US interest rates would affect a large part of Africa through indirect channels. Firstly, the likely global recession would

Table 3 Annual Changes in the Terms of Trade of Africa and Developing Asia, 2001-2005
(in percentages)

	Africa	Developing Asia
2001	-3.2	-0.1
2002	-0.6	1.3
2003	1.7	-0.3
2004	4.1	-2.1
2005	13.7	-1.5

Source: IMF (2006).

reduce global demand and the demand for the continent's exports. Secondly, the more sophisticated economies of South Africa, Nigeria and Egypt would be adversely affected by the increased costs of accessing financing from global financial markets. This would in turn affect the rest of Africa through spillover effects.

Eichengreen and Park indicated that from their perspective, the trade channel is the most important channel in examining the implications of the global imbalances and the approaches to deal with them. Of particular interest is the argument that a wide current account deficit supports a high global aggregate demand and helps sustain and redistribute global growth. An unwinding of the trade deficit may lead to global recession in the absence of compensatory expansionary policies in Asia and Latin America. Table 3 presents annual percent changes in the terms of trade of Africa and Developing Asia. The terms of trade were clearly less favourable to Africa in earlier years than more recently, following the rise in the prices of non-fuel commodities in response to strong global demand. Any reversal in global demand toward the historical mean would bring more suffering in Africa than in Developing Asia. This is more so the case given increased Africa-US trade following the African Growth and Opportunity Act (AGOA) and Everything-But-Arms (EBA) initiatives.

In both the chapters by Eichengreen *et al.* (2006) and D'Arista *et al.* (2006), there is extensive discussion of options for counter-cyclical policies that could be considered by developing countries individually or as a group. But as indicated above, a number of the market-based policies recommended have limited applicability in Africa where the financial sector remains shallow and lacks sophistication. There is an

urgent need for the IMF to probe these ideas further with a view to designing counter-cyclical policies applicable for countries in Africa.

4 Conclusion

From the analysis above, which has shown differing economic situations and experiences in Africa and Asia, it would be inappropriate to generalise on the implications of global balances and its adjustment approaches. Indeed, both country and regional analysis would be helpful in prescribing relevant and feasible policy actions. In addition, apart from a coordinated policy approach referred to earlier, the time is ripe for a reform of the international financial architecture to design more effective counter-cyclical measures plus oversight and regulation of the global financial system. In the case of Africa, there is an urgent need to design instruments that assist in mitigating the risk in highly volatile commodity markets. Previous efforts failed partly because they neglected long-term market trends or were based on only governments buying the insurance cover. There were also cases when disbursements from emergency schemes were not time sensitive. There is need for mechanisms that can supplement commercial systems of shock prevention designed to deal with all shocks as opposed to individual risks.

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