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Assessment of global imbalances

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GLA Economics provides expert advice and analysis on London's economy and the economic issues facing the capital. Data and analysis from GLA Economics form a basis for the policy and investment decisions facing the Mayor of London and the GLA group. The unit is funded by the Greater London Authority, Transport for London and the London Development Agency.

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Executive summary

The term 'global imbalances' has attracted a great deal of commentary of late. Much of the discussion has focussed on the US running a sizeable and increasing current account deficit on the one hand while Asian and oil-exporting countries record large current account surpluses on the other. Another aspect of global imbalances concerns the large international capital flow towards the US, which as we shall see finances its current account deficit. However, opinion is sharply divided over the causes of global imbalances and their significance. Views also differ markedly on the size and speed of any corrective measures designed to rebalance US finances, whether or not these imbalances will unwind gradually and non-disruptively, or whether or not sudden change of sentiment in financial markets could result in a damaging adjustment. On the one hand there is the view that, unless major policy actions are taken, these imbalances will lead to global financial turbulence[1]. On the other, there is the view that the imbalances are the harmless outcome of various events such as differences in productivity growth, 'global saving glut', or valuation effects[2].

These issues have come even more into focus in the current turbulent times and with the US dollar falling. At present large, unbalanced financial positions are leaving the world economy vulnerable to economic shocks in the face of sharp exchange rate swings. We need to go beyond assessing cyclical developments and concentrate on longer-term factors and the exchange rate and interest rate mechanisms which underlie and help explain the current situation.

The purpose of the paper is to answer the following questions:

1. What are global imbalances?
2. How are they caused? Which theory best explains their existence?
3. Is it a problem?
4. What are the implications? More specifically, what threats and opportunities for adjustment do global imbalances pose for the world and, in particular, London?

By tracking global developments in current and capital account movements from 1980-2006, we find that global imbalances refer to large asymmetries in trade and finance between regions, most notably, the US current account deficit vs. the Chinese current account surplus. Observations of global current account trends illustrate that the US is the main contributor to global imbalances with a current account deficit that has risen sharply since 1991. Country comparisons show that the US deficit is the world's largest and stood at $857 bn (6.5 per cent of US GDP) in 2006. In stark contrast is China's current account surplus (the world's largest), which stands at roughly $106.8 bn.

[1]Summers (2004), Obstfeld & Rogoff (2004), Roubini & Setser (2005), Blanchard, Giavazzi & Sa (2005).
[2]Backus, Henriksen, Lambert & Telmer (2005), Bernanke (2005), Croke, Kamin and Leduc (2005), Gourinchas and Rey (2005), Hausmann & Sturzenegger (2005), Lane and Milesi-Ferretti (2005), Caballero, Farhi & Gourinchas (2006), Cavallo and Tille (2006).

Regional comparisons make the UK's current account deficit ($80 bn) look favourable when comparing it with the US but within Europe, the UK's deficit stands as the largest and has been steadily growing since 1997. The UK's current account balance is negative due to its deficit on trade in goods such as foodstuffs, raw materials and motor vehicles despite maintaining a surplus on trade in services e.g. insurance, finance and business. Much of this surplus is generated in the global financial centre of London (estimates put the value of service exports at £38 bn in 2005 which includes a positive adjustment of roughly £3 bn to account for recently improved estimates of the export value of Financial Intermediation Services Indirectly Measured (FISIM)).

To balance a country's accounts, a deficit on the current account requires a surplus on the capital account (net export of capital or assets etc.). This is the case with the US, which maintains a large capital account surplus where a surge of portfolio investment since 1997 has been a key driver of the account. A closer look at US portfolio investments since 1980 reveals that the rise in investment has been attributed to debt securities (US treasury bonds, money market instruments) where Asian countries such as China have been buying a large number of US bonds to limit the appreciation of their exchange rates and thereby boost their own exports.

On the causes of global imbalances, a review of international literature on the topic converges on two widely accepted theories, the *consumption boom* and *global savings glut*. In essence both theories are complementary and represent different but closely related features of the same idea. The willingness of Asian countries to finance a domestic consumption binge in the US where personal savings rate is near zero is evident. Enormous US dollar denominated reserves in Asian central banks (accounting for roughly 75 per cent of the overall increase in outstanding US treasuries from 1985 to 2005) help both stabilise their exchange rates, insure against capital flight and also serves the US by allowing them to run a large budget deficit without having to impose higher interest rates.

Global imbalances pose potential problems for the US and the rest of the world due to the fact that the sustainability of the large and persistent current account deficit in the US relies on the willingness of foreign investors to continue accumulating net claims on the US. Debt of this magnitude (US debt is 75 per cent of the world's total) questions the very ability of the US to repay – its basic solvency. The more overseas debt that America runs up, the greater the risk that it will partly default on its obligations, either through currency weakness or inflation. Likewise central banks or private investors in Asia or oil exporting countries may believe that the US is not willing and not able to generate sufficient current account surpluses to repay what it has borrowed. If so, the US will find it difficult to continue running a current account deficit. This will have implications for the rest of the world given the interdependent nature of the global economy.

A clear implication is that global current account adjustment should prioritise the improvement of the US current account (via its trade balance) rather than its capital account (international investment position). There are two mechanisms which will enable this. Firstly, what is needed are movements in exchange rates where the demand for foreign exchange shifts from net borrowers such as the US to net lenders such as Japan (i.e. a significant

depreciation in the US dollar and corresponding appreciations in other key currencies). Secondly, movements in interest rates are important to rebalance demand and saving between the US and Asia and across the globe. A savings-investment analysis suggests we need greater savings in the US, higher investment in the Asian economies, and greater consumption in China to narrow global imbalances.

The main area of concern for the UK is how the movement in exchange rates will impact on their exports. For example a weak US dollar gives US firms a competitive edge over UK firms by making US exports cheaper. For London, a weak US dollar poses the same challenges but also opportunities since the city is home to numerous large US financial and business service corporations where London features as a key foreign currency revenue base. The recent financial turmoil reinforces London's need to act strategically and maintain long-term competitiveness in this sector – it is not only a fast growing sector, but also a key source of innovation.

Global accounts reveal that emerging markets present huge opportunities for London. The US and the EU still remain the UK's main trading partners but in recent years import and export activity between the UK and China has been growing the fastest. Exports to China grew £4.4 bn (365 per cent) and imports from China grew £14.2 bn (560 per cent) between 1996 and 2006. The figures for exports and imports with another emerging trading partner, India, are £2.9 bn (122 per cent) and £3.6 bn (137 per cent) respectively. India is now the UK's third largest foreign investor after the US and Japan (in 2006, 46 Indian companies invested in the UK with 27 locating in London alone). China and India's need to invest in future growth offers opportunities for London's firms and talent to provide what it does best - corporate finance and business services and related activities such as accountancy and legal support in regulatory reform and system architecture.

1. Introduction

Structure of the paper

Section 1 presents the mechanisms behind the balance of payments and introduces the role of the US current account deficit to global imbalances. Section 2 assesses global current and capital account developments by region, in the context of the 1980-2006 experience including the UK's and London's unique position in the global economy. Section 3 explores two widely accepted theories on the possible causes of the massive increase in global imbalances over the past 10 years. Section 4 examines the problem of how and why the current situation is (un)sustainable and presents two scenarios on the future path of global imbalances: a permanently higher world oil price and an appreciation of the Yuan. Also included in this section is a discussion of the implications of unprecedented global imbalances - what adjustment holds for the world and London. Section 5 concludes the discussion.

A note on data

There is no single consolidated data source for global current and capital accounts. Instead, we rely on national balance of payments data. In the case of countries such as China, for example these may not be completely consistent with accepted international statistical standards. The closest to a consolidated set of accounts are the International Financial Statistics (IFS) held by the International Monetary Fund (IMF). The most recent balance of payments data are for 2006 and the latest country Gross Domestic Product (GDP) data were published in April 2007[3].

Figures for both current and capital accounts are denoted in $US billion except for a separate discussion on the UK and London where figures are quoted in pound sterling. Regions[4] were constructed in the same way as defined by the IMF in its World Economic Outlook (WEO) publication. Only those countries that had data on both current/capital accounts and GDP were included. As such, the data will not always 'sum to zero' (as it should in theory).

1.1 The balance of payments

The balance of payments is a record of international transactions between residents[5] of one country and the rest of the world. International transactions include exchanges of goods, services or assets.

[3] For some countries, however, information on the current account is not yet available from the IMF, International Financial Statistics data.
[4] For detail description of countries within the different regions, see Appendix 1.
[5] Residents mean businesses, individuals and government agencies, including citizens temporarily living abroad but excluding local subsidiaries of foreign corporations.

Transactions are divided into two broad groups: Current Account and Capital Account[6]. The current account is made up of *visible trade* (merchandise exports and imports) and *invisible trade* (income and expenditure for services such as banking, insurance, tourism and shipping; profits earned overseas; interest and dividends; and transfer payments such as foreign aid). The capital account is made up of inward and outward flow of money for investment and international grants and loans. This includes foreign direct investments (FDI), portfolio and other investments (derivatives, stocks, bonds etc.); capital transfers (debt forgiveness, inheritances and migrants' funds, the transfer of ownership on fixed assets etc); and reserves.

It is important to stress that these are related through an accounting identity: as Table 1 shows, they arithmetically sum together, to equal zero including net errors and omissions[7].

Table 1: Accounting identities in the balance of payments

CREDITS (Payments from foreigners)	**DEBITS (Payments to foreigners)**
(1) Exports of goods and services	(2) Imports of goods and services
1 – 2 = Visible balance	
(3) Incomes and current transfer payments from abroad	(4) Incomes and current transfer payments going abroad
3 – 4 = Invisible balance	
(1 – 2) + (3 – 4) = Current account balance	
(5) Capital transfers to UK from abroad	(6) Capital transfers abroad from UK
(7) Investment (direct, portfolio and other) from abroad	(8) UK investment (direct, portfolio and other) abroad
(9) Drawing on reserves	(10) Adding to reserves
(5-6) + (7-8) + (9-10) = Capital account balance	
Current account + Capital account = Balance of Payments	
Overall balance of payments plus net errors and omissions = 0	

Note: By convention, the IMF denotes capital account debits with a negative sign.

Each credit transaction has a balancing debit transaction, and vice versa, so the overall balance of payments should in theory always balance. This demonstrates how national balances of payments fit together as interdependent elements of a much larger system.

Table 2 presents the top 20 countries in terms of global trade in 2006. Trade is measured by summing each country's total exports and imports. In 2006 the US was the largest trading nation in the world, followed by Germany, China and Japan. With roughly 14 per cent of global trade and the largest current account deficit in the world, the US economy plays a dominant role in global economic affairs.

[6] Since 1999 the IMF split the capital account into the 'capital and financial account' but for the purposes of this paper we refer back to the traditional categorisation of a current and capital account. For more details about the capital account's components see Appendix 2.

[7] The balancing components (i.e. the residuals) tend to be the drawing/adding on reserves and the net errors and omissions components.

Table 2: Top 20 trading nations in 2006, $US Billion

Country	Trade: exports + imports	% of world trade
1. United States	2,958	13.7
2. Germany	2,045	9.4
3. China	1,761	8.1
4. Japan	1,230	5.7
5. France	1,025	4.7
6. United Kingdom	976	4.5
7. Italy	857	4.0
8. Netherlands	758	3.5
9. Canada	747	3.5
10. Belgium	723	3.3
11. Hong Kong	651	3.0
12. South Korea	635	2.9
13. Spain	539	2.5
14. Mexico	512	2.4
15. Singapore	511	2.4
16. Russia	485	2.2
17. Taiwan	427	2.0
18. India	295	1.4
19. Malaysia	292	1.3
20. Sweden	274	1.3
World trade	**21,651.2**	

Source: Ecowin, International Financial Statistics and World Economic Outlook from IMF

When a country's saving exceeds its investment in a particular year, this excess saving can be lent on international capital markets. Conversely, if a country is saving less than the amount required to finance domestic investment, the country can borrow from abroad to close the gap between saving and investment. For example when US receipts from its sales of exports and other current payments are insufficient to cover the cost of US imports and other payments to foreigners, US households, firms, and governments must borrow the difference on international capital markets. Thus, essentially by definition, in each period US net foreign borrowing equals the US current account deficit, which in turn is closely linked to the imbalance in US international trade. It is in this way that the overall balance of payments sums to 0.

Table 3: Balancing sources and uses of funds

Sources of funds		**Uses of funds**
Income, Liabilities, Foreign Direct Investment	**Equals**	Consumption, Investment, Assets, Overseas investment
Income – Consumption		Investment, Assets – Liabilities Overseas investment – FDI
Saving		Investment

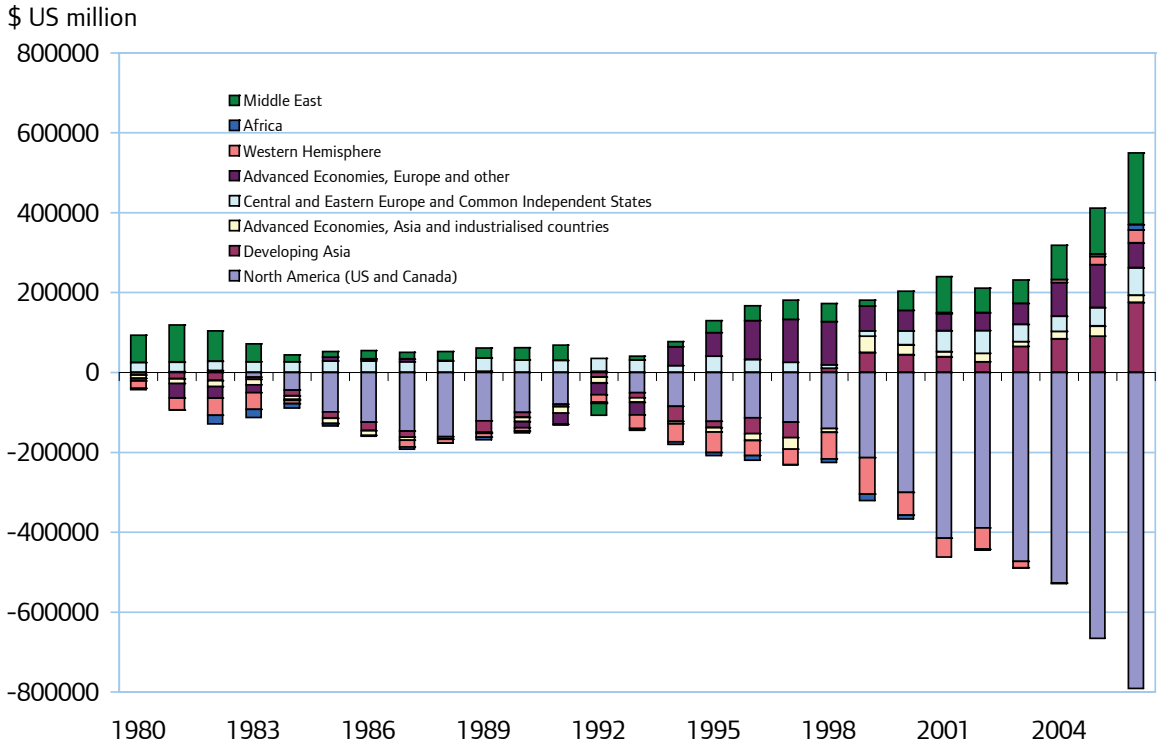
A country has different sources of funds and uses of funds and can borrow from loans, equity securities or through foreign direct investment. In accounting terms, sources and uses of funds must balance – and indeed this is used as the starting point for most official economic accounts (see Table 3). And just like an individual, whether or not a country can run a current account deficit (borrow more) depends on the extent of its foreign liabilities (its external debt) and on whether their credit rating is good and if the borrowing will be financing investment that has a higher marginal product than the interest rate (or rate of return) the country has to pay on its debt.

2. Observations

2.1 Global current accounts

As the broadest measure of the net flow of trade and income, the current accounts of the world should, in theory, sum to zero. That is, any increase in any country's current account deficit must be matched by a surplus in other countries.

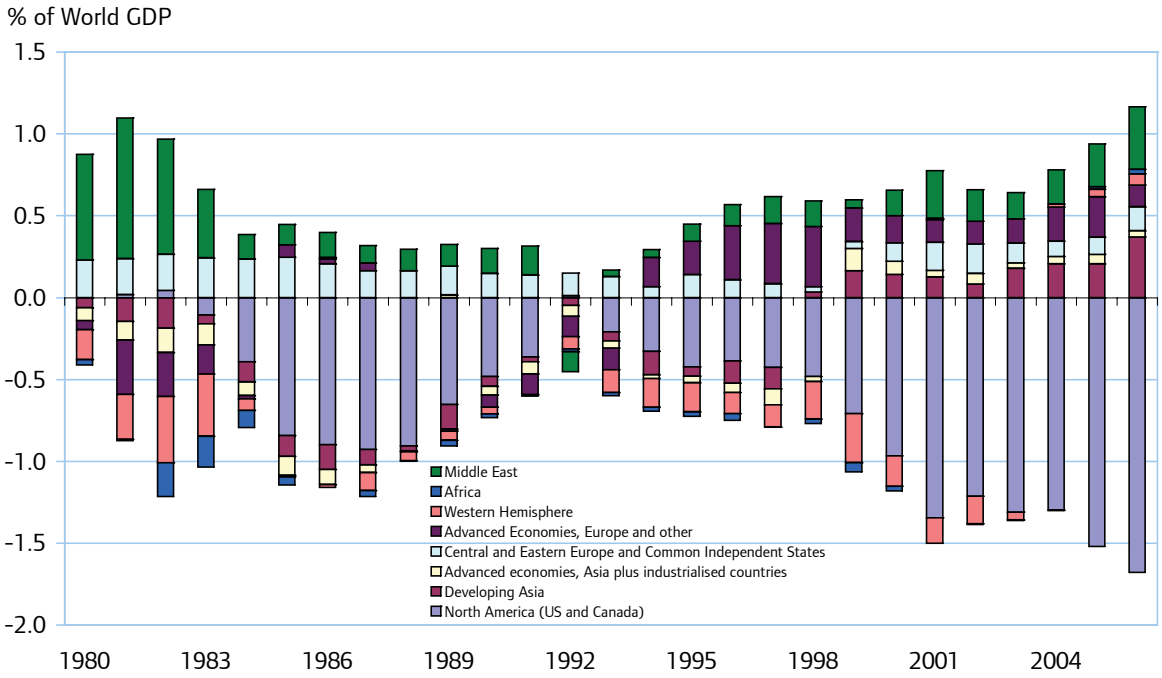
Figure 1: Current accounts in absolute terms, 1980-2006



Source: Ecowin, International Financial Statistics *and* World Economic Outlook *from IMF. See Appendix for country breakdown by region.*

Figure 1 illustrates the true extent of North America's widening current account deficit, which is attributable to the large surge in the US current account deficit. The US exceeded $857 billion (6.5 per cent of US GDP) according to the US Bureau of Economic Affairs latest data for 2006. Figure 1 also shows how Developing Asia moved from current account deficit to surplus after the Asian crisis in 1997. History tells us that emerging markets aren't able to sustain current account deficits without facing a crisis.

Figure 2: Current accounts as a proportion of world GDP, 1980-2006



Source: Ecowin, International Financial Statistics and World Economic Outlook from IMF

Figure 2 shows that North America (predominantly the United States) has become the main contributor to global imbalances in trade flows. Firstly, there has been a strong increase in North America's current account deficit, which was roughly in balance in 1991 but has since risen continuously to a record 1.7 per cent of world GDP in 2006. Secondly, Japan, emerging economies such as China, and oil producing nations have recorded substantial current account surpluses since the Asian crisis of 1997-98. Underlying China's surplus is exports which account for more than a third of China's economic growth and 10 per cent of overall GDP (four years ago exports contributed nothing to headline growth figures)[8].

Table 4 presents the current account balance trend for a number of key economies with the ones in red experiencing a deficit in the most recent period. In addition to showing the sheer magnitude of the US deficit, it illustrates how emerging economies such as Thailand, Brazil and Argentina have moved their current accounts into surplus.

[8] Anderlini (2007).

Table 4: Current account balances $US billion, latest and selected years

	1992	1996	2000	2004	2006
United States	-50.1	-124.7	-415.1	-665.3	-856.7
Canada	-21.2	3.4	19.6	21.2	20.8
Japan	112.6	65.8	119.7	172.1	165.8
Argentina	-5.5	-6.8	-9.0	3.4	8.0
Brazil	6.1	-23.2	-24.2	11.7	13.3*
Mexico	-24.4	-2.5	-18.7	-6.6	-1.9
Germany	-22.6	-14.0	-32.0	101.8	146.9
Spain	-21.5	-2.2	-23.1	-54.9	-106.4
United Kingdom	-23.4	-11.3	-36.7	-43.0	-80.0
Italy	-29.2	40.0	-5.8	-15.7	-47.5*
France	3.9	20.6	18.6	-6.8	-42.6*
China	6.4	7.2	20.5	68.7	106.8**
South Korea	-4.1	-23.2	12.3	28.2	6.1
Thailand	-6.3	-14.7	9.3	6.9	3.2
Saudi Arabia	-17.7	0.7	14.3	51.9	104.1*
Russia	NA	10.8	46.8	58.6	95.6

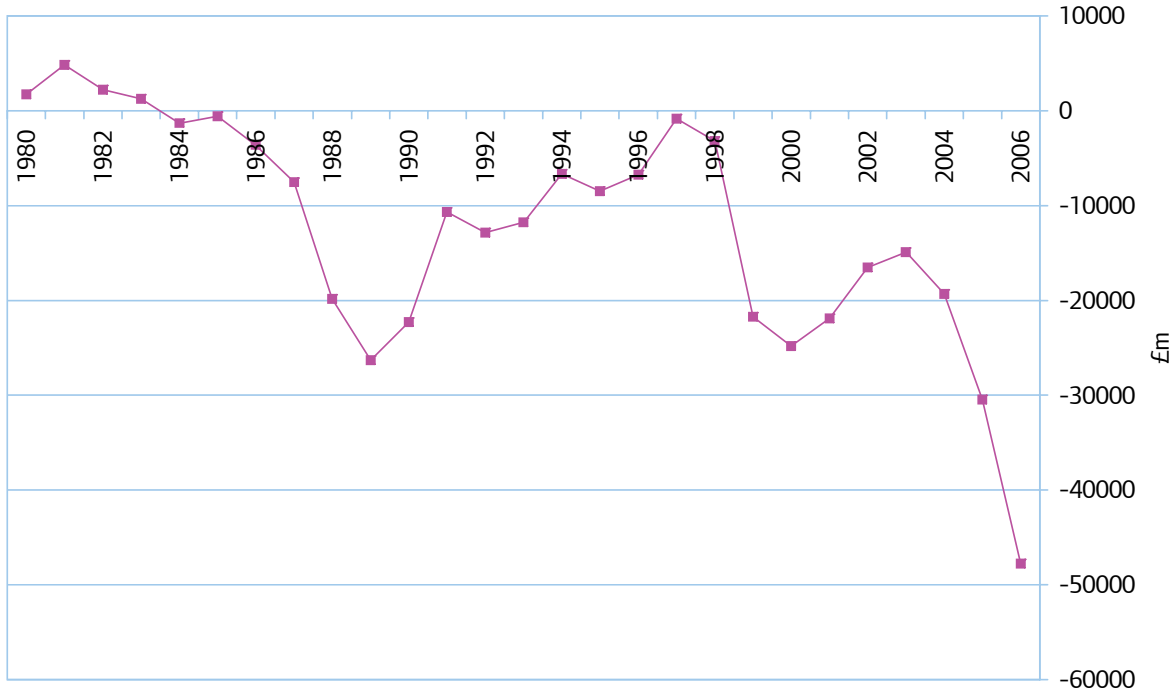
Source: Ecowin and International Financial Statistics from IMF.
*Notes: *2006 estimate. **2005.*

At face value the US current account deficit looks undesirable - reflecting reckless fiscal policy or a consumption binge. Alternatively though, it could reflect a productive economy associated with new technology or domestic demand exceeding supply where the country is temporarily living beyond its means to import goods today and export goods in the future. To understand whether or not a deficit is 'good' or 'bad', we have to explore the underlying economic conditions of a country at a particular point in time.

In deficit: the UK

Since 1997 the UK has consistently run a current account deficit (the largest in Europe). Despite running a surplus on trade in services e.g. insurance, finance and business, this is outweighed by the deficit on trade in goods. The UK is a net importer of foodstuffs and raw materials, as well as of clothing and footwear, electrical machinery and motor vehicles. The UK is a net exporter of chemicals products (particularly pharmaceuticals), tobacco, beverages and mechanical machinery.

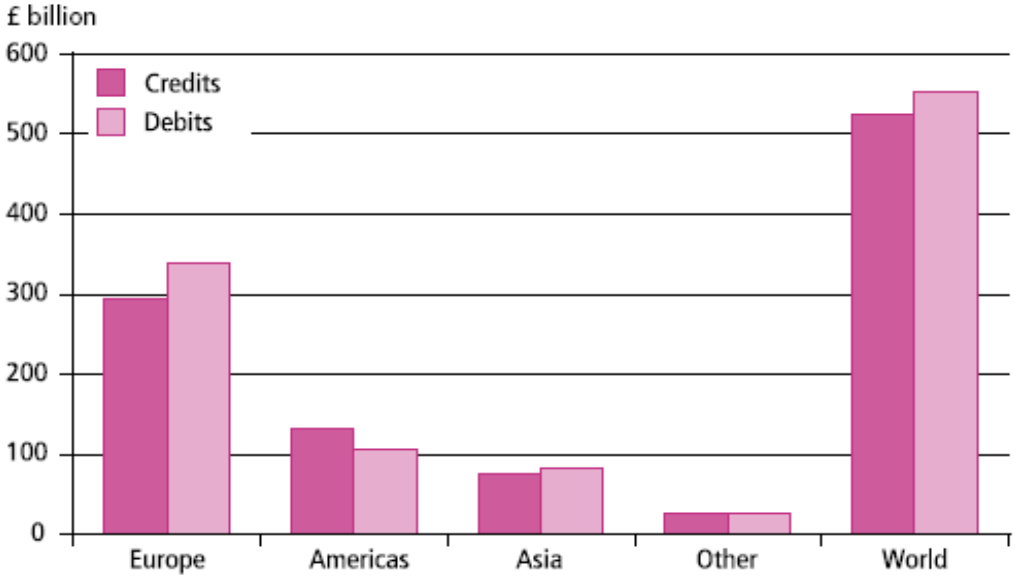
Figure 3: UK current account balance 1980-2006 (£ millions)



Source: ONS National Statistics, UK Balance of Payments

Figure 3 shows that in 2006 the UK's current-account deficit totalled £47.8bn (roughly $80bn), or 3.7 per cent of GDP.

Figure 4: UK current account by world region 2005

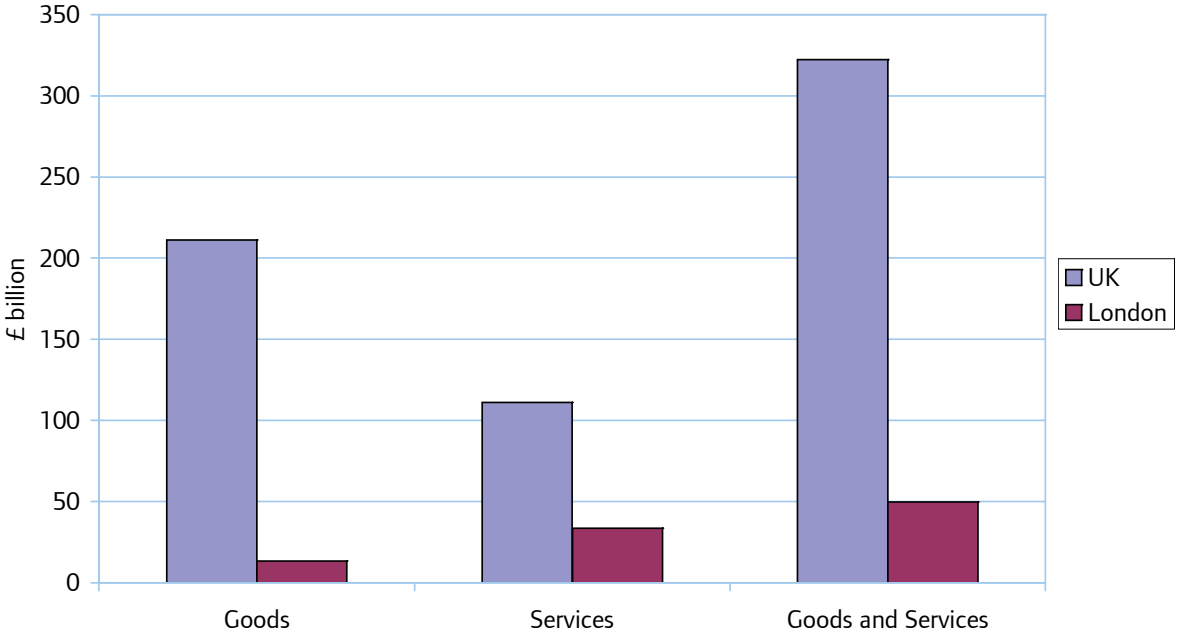


Source: ONS Pink Book 2006

Figure 4 shows that in 2005, around 60 per cent of current account credit and debit transactions were with Europe - the UK's largest trading bloc. The UK's largest single trading

partner, the US, represented almost 80 per cent of total current account credits and debits from North America. Whilst Japan remains the UK's largest current account partner country in Asia, transactions with China have grown the fastest in recent years. Exports to China grew £4.4 bn (365 per cent) and imports from China grew £14.2 bn (560 per cent) between 1996 and 2006. The figures for exports and imports with another emerging trading partner, India, are £2.9 bn (122 per cent) and £3.6 bn (137 per cent) respectively[9].

Figure 5: Exports of UK and London goods and services, 2005



Source: GLA estimates using EcoWin, Pink Book, ONS Annual Business Inquiry for UK jobs.

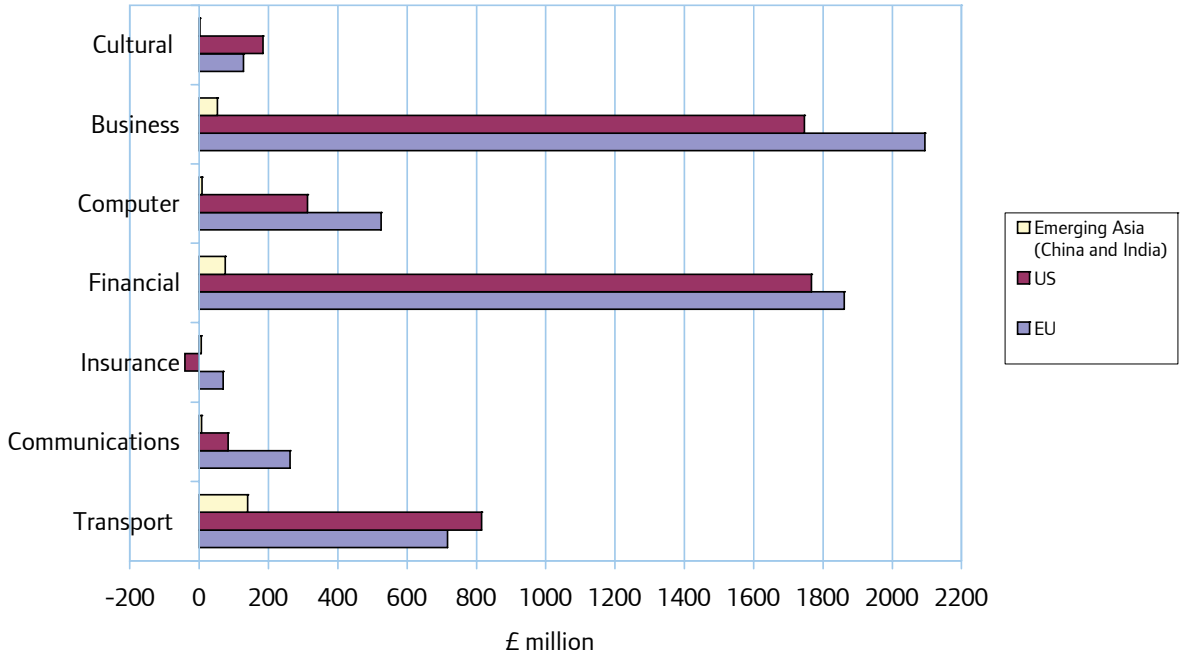
As one of the main global trading centres and significant to the UK's surplus with the rest of the world, London's comparative advantage lies in its export of services. London's share of total UK service (mainly financial and business service) export jobs is estimated to be 24 per cent (equivalent to 1.5 million jobs), valued at £28.9bn in 2005. In addition to spending by overseas visitors in London (£6.1 billion in 2005)[10] and a positive adjustment of roughly £3 billion to account for export of Financial Intermediation Services Indirectly Measured (FISIM),[11] estimates put the total value of London's service exports at £38 billion for 2005 (see Figure 5). Roughly 20 per cent (£7.6 billion) of this £38 billion is accounted for by financial and business services trade with the EU and US alone, as depicted in Figure 6. In contrast, London accounts for only 6 per cent of total UK exports in goods. Total exports from London combining goods with services, equalled £49.8 billion in 2005 or 15.5 per cent of UK goods and services exports fuelled mainly again by US and EU import demand.

[9] ONS PinkBook 2007.

[10] London's exports of personal travel and business travel are estimated separately from other calculations using data from the ONS Pink book and London and UK level expenditure from the International Passenger Survey (IPS).

[11] Rosewell and Wiltshire (2007) show that in 2004 National Accounts underestimated net exports of indirect financial services for London by £2.43 billion. This was an estimate based on a headline GVA (ONS workplace analysis) figure of £195 bn for London in 2004. London's GVA (ONS workplace analysis) in 2005 was £203.642 bn.

Figure 6: Estimated value of London's key service exports by sector and by trading partner (main and emerging), 2005



Source: GLA Economics estimate using EcoWin, Pink Book, ONS Annual Business Inquiry *for GB jobs. The method uses employment as a proxy for exports. London's share (x per cent) of UK employment in each sector is used to derive its proportional export value in each sector. No adjustment is made for the higher productivity of London's employees, or a potentially higher rate of export intensity in London.*

Strong bilateral trade in finance and business services between the US and UK is also replicated at city level between the two global financial centres[12] of London and New York. As economic powerhouses of their respective countries, their fortunes are strongly linked to bilateral and international financial flows. Recent research on inter-city connectivity of the 100 specialised global corporate services firms including those specialising in law, advertising, management consulting, accounting and insurance demonstrates how London and New York have far greater connectivity than other financial centres[13].

[12] According to the City of London's *The Global Financial Centres Index 2*, London and New York are the only two cities which have sufficient critical mass of financial services institutions to act as an intermediary, connecting international, national and regional financial services participants directly.

[13] Measure of connectivity is derived from the office networks of these firms which operate in 315 cities worldwide, each firm with offices (either headquarters or branches) in at least 15 countries. These global firms produce and deliver critical inputs for other firms, markets and even governments around the world. They service businesses involved in commodity trading and the futures markets, as well as for the financial services firms. They also service enterprises as diverse as architectural and engineering firms, major international art exhibitions, cultural events and biennales, and even avant-garde circuses (Mastercard Worldwide (2007)).

Table 5: City connectivity – number of office networks

Financial Centre	Gross Connectivity	Connectivity Ranking (out of 24 cities)	Relative connectivity (London = 1.000)
London	11,798	1	1.000
New York	11,524	2	0.978
Tokyo	8,533	3	0.724
Milan	7,178	4	0.609
Los Angeles	7,068	5	0.600
Sao Paulo	6,561	6	0.557
Mumbai	5,579	10	0.473
Shanghai	5,293	11	0.449
Seoul	5,210	12	0.442
Moscow	5,079	13	0.431
Johannesburg	5,026	14	0.426
Dubai	4,033	21	0.342

Note: Calculations were made using the Taylor methodology applied to and measuring the connectivity among a sample of 24 cities.
Source: MasterCard Worldwide (2007).

However a high level of connectivity also means higher competition. As depicted above, New York remains London's main competitor in the export of finance and business services (a large sector growing in importance). Staying ahead of the competition means London has to exploit and weather global fluctuations in trade and finance (more on this in section 4).

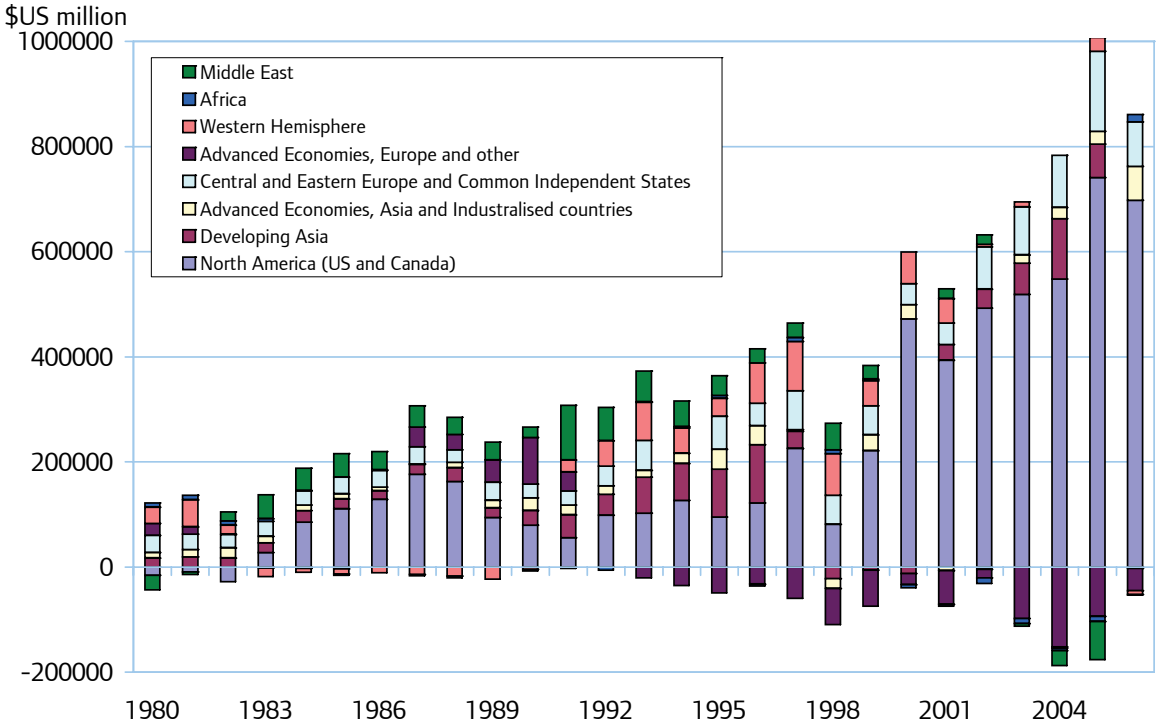
2.2 Global capital accounts

Capital accounts capture the investment inflows and outflows of a given country with the rest of the world. Economic growth requires investment in new capital goods and the upgrading and replacement of older capital. Capital investment includes the construction of homes, factories and office buildings and firms' acquisition of new equipment, ranging from computers to airplanes.

All investment in new capital goods must be financed in some way and in a closed economy without trade or international capital flows, the funding for investment would be provided entirely by the country's national saving from households and businesses. However almost all economies are open, thus savers can lend to those who wish to make financial investments in any country, not just their own. Because saving can cross international borders, a country's domestic investment in new capital and its domestic saving need not be equal in each period. When a country's saving exceeds its investment, the difference represents excess saving that can be lent on international capital markets (e.g. emerging Asian economies and oil-exporting countries). Whereas if a country's saving is less than the amount required to finance domestic investment, the country can close the gap by borrowing from abroad (the US uses foreigners' saving to finance part of its domestic investment).

The capital account consists of five different components: direct investment; other investment; portfolio investment; financial derivatives securities; and reserve assets, more details of which are given in Appendix 2.

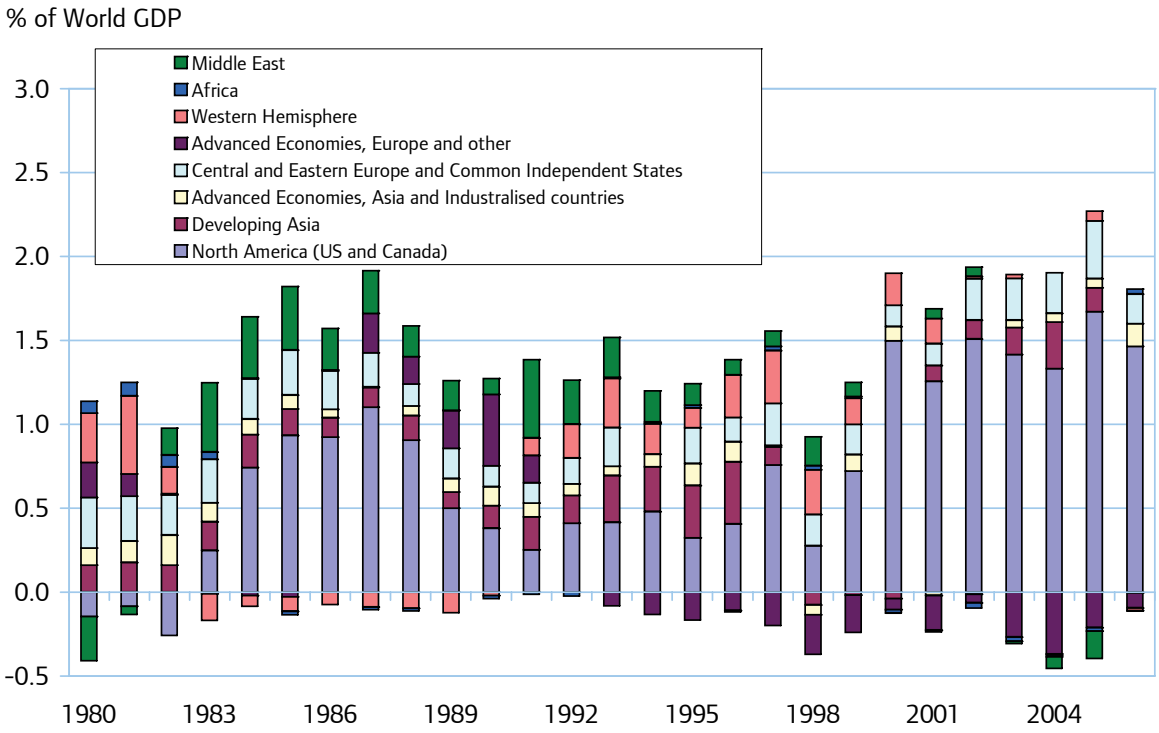
Figure 7: Capital accounts in absolute terms, 1980-2006



Source: Ecowin, International Financial Statistics and World Economic Outlook from IMF

Figure 7 shows that the continent of North America has recorded a surplus in its capital account since 1983, mainly due to large inflows of foreign capital, which soared from an average of $50 billion a year in the 1980s to $700 billion in 2006. Without this, their current account deficit could not be maintained. For the US this surplus is slightly lower than the deficit recorded in its current account. Thus the remaining difference (current account deficit) has to be balanced by the capital account and/or the errors and omissions term. For example as we shall see in Table 6, all countries that registered a surplus in their capital account in 2005 are also countries that recorded a current account deficit.

Figure 8: Capital accounts as a proportion of world GDP, 1980-2006



Source: Ecowin, International Financial Statistics and World Economic Outlook from IMF

Figure 8 shows that in 2006 North America registered a capital account surplus of approximately 1.5 per cent of world GDP. In the same year advanced economies in Asia and industrialised countries (Australia and New Zealand) recorded a surplus of similar magnitude to that of Central and Eastern Europe and the CIS (0.2 per cent of world GDP).

Table 6 shows a breakdown of the capital account for various countries in 2005. As evidenced some emerging economies in Asia and the Middle East were net lenders in 2005. It is apparent that the US is an overwhelming absorber of global savings but less clear is why China is a net borrower given its current and capital surpluses. As we shall see, China's extensive capital controls can help explain this.

Table 6: Components of the capital account, 2005, US$ bn, net transactions (flows)

	Direct investment	Other investment	Portfolio investment	Financial derivatives	Total capital account
Net borrowers					
Unites States	100.7	-57.8	728.4	0.0	771.4
China	67.8	-4.0	-4.9	0.0	58.9
Spain	-16.2	36.7	52.2	-0.2	72.5
United Kingdom	62.3	39.9	-52.6	-4.4	45.2
Mexico	11.9	-9.3	10.2	0.0	12.8
South Korea	0.0	4.1	0.3	-1.7	2.8
Italy	-21.1	-15.3	56.3	3.1	23.0
France	-62.9	26.4	-11.8	9.9	-38.5
Net lenders					
Thailand	3.7	-1.5	5.7	0.8	8.7
Russia	1.8	15.8	-11.5	-0.2	5.8
Hong Kong	3.3	-2.2	-21.6	1.8	-18.6
Canada	0.0	8.3	-35.8	0.0	-27.5
Sweden	-16.9	-8.6	4.1	-0.8	-22.2
Saudi Arabia	-2.4	-37.2	-48.0	0.0	-87.6
Netherlands	-74.7	-24.4	81.9	-4.3	-21.5
Switzerland	-36.7	-1.9	-47.6	0.0	-86.3
Japan	-42.2	-60.7	-13.3	-6.5	-122.7
Germany	-15.1	-90.4	-15.1	-6.1	-126.6

Source: Ecowin, International Financial Statistics from IMF

As depicted in Table 7 the US is the largest foreign direct investor in the world: the value of the stock of US-owned foreign direct investment (FDI) in other countries at the end of 2005, measured at market values, was US$3.5 trn. The countries that receive large amounts of direct investment from the US are essentially the same as those that provide large amounts of investment in the US, namely the UK, Netherlands, Japan, Germany and Canada. The most important single owner of FDI in the US is the UK, which in 2005 accounted for about 17 per cent of the US inward direct investment stock in 2005.

Table 7: US foreign direct investment, 2005

Total at market values ($ bn)	
Foreign-owned FDI in US	2,797.2
US-owned FDI in other countries	3,524.5

Source: EIU (2007). US Country Forecast 2007. *Data from US Bureau of Economic Analysis, Survey of Current Business.*

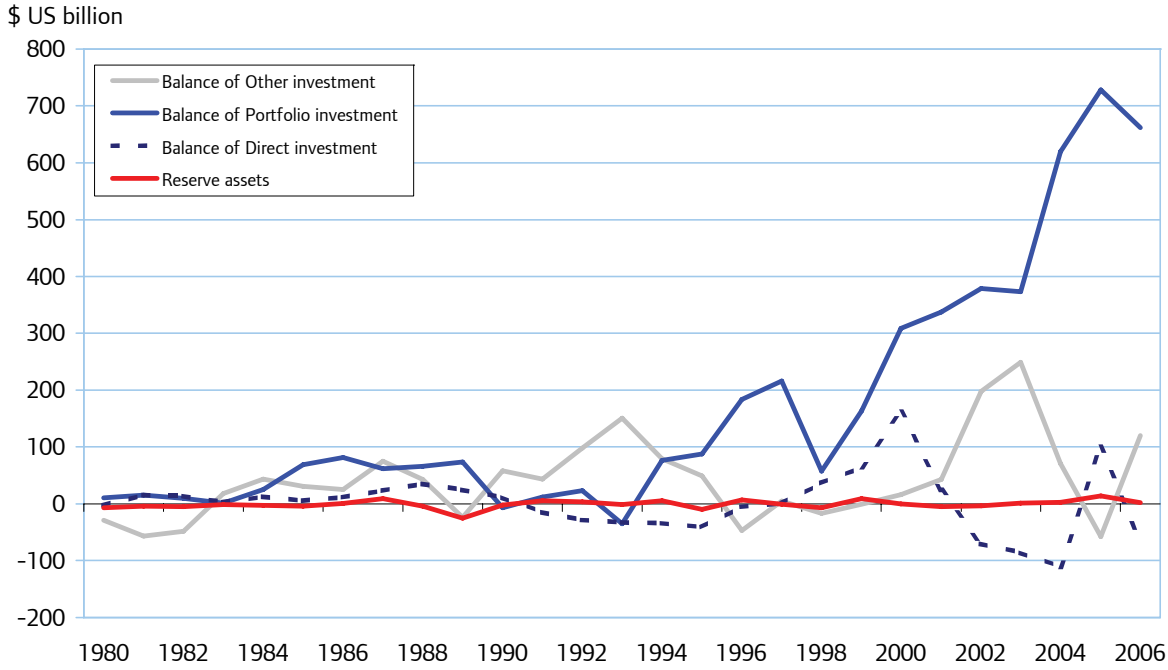
FDI is defined as investment to acquire a lasting interest in enterprises operating outside of the economy of the investor. Portfolio investments on the other hand are short-medium term, passive holdings of securities such as purchase of shares in a foreign company, purchase of bonds issued by a foreign government, or acquisition of assets in a foreign country – all of which do not entail active management or control of the securities' issuer by the investor. Portfolio investments are usually more liquid and interest-rate sensitive, and therefore more likely to be transitory. The rapid liquidation of portfolio investments has in some instances exacerbated international financial crises, as was the case during the Asian

crisis of the late 1990s. Derivatives are financial instruments usually in the form of futures, forwards, options, and swaps whose value is *derived* from the value of something else.

The US capital account

Figure 9 shows that the sharp surge in the portfolio investment component since 1997, which includes debt and equities securities has driven the US capital account, and has to some degree offset its current account deficit. A deficit on the current account (a net import balance of goods and services) requires a surplus on the capital account (the net export of the ownership of capital or other real assets) to pay for it. In 2005 the value of portfolio investments appeared to reach its peak at around $700 billion.

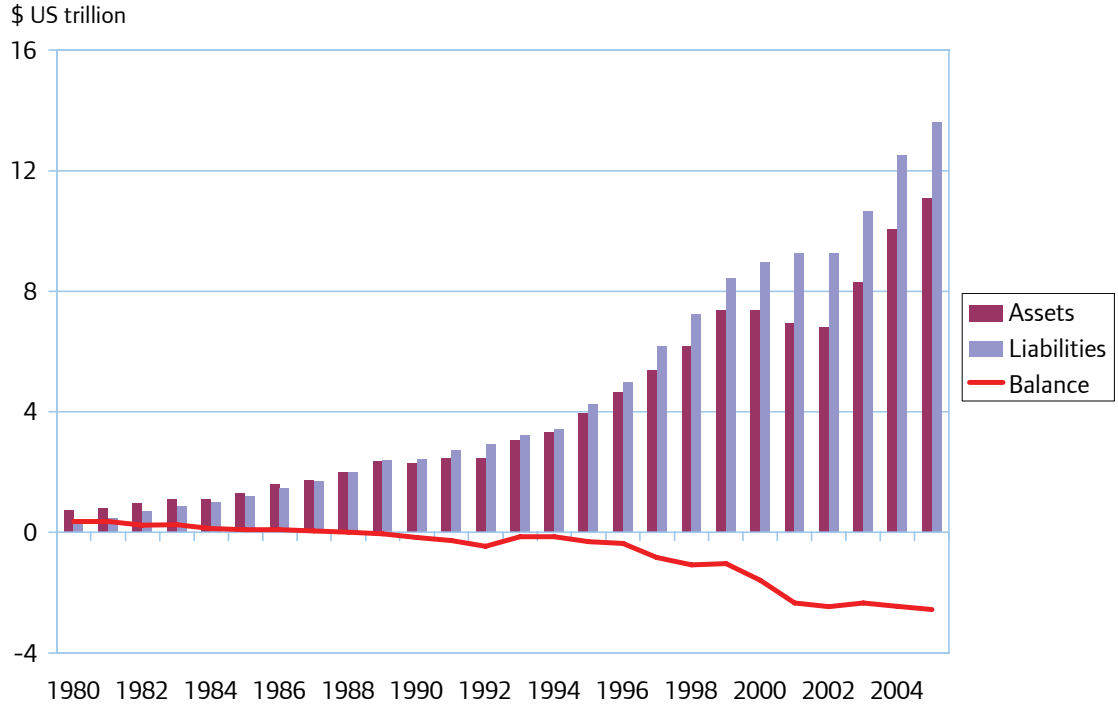
Figure 9: US capital account components (by instrument), 1980-2006



Source: Ecowin and International Financial Statistics from IMF.

Figure 10 depicts the US international investment position, which measures its net foreign asset position at a given period (in stocks), including revaluations in asset prices and exchange rates (see Appendix 2 for details). Although the growth rate in US assets has increased rapidly over recent years, US liabilities have grown at an even faster rate as evidenced in Figure 10.

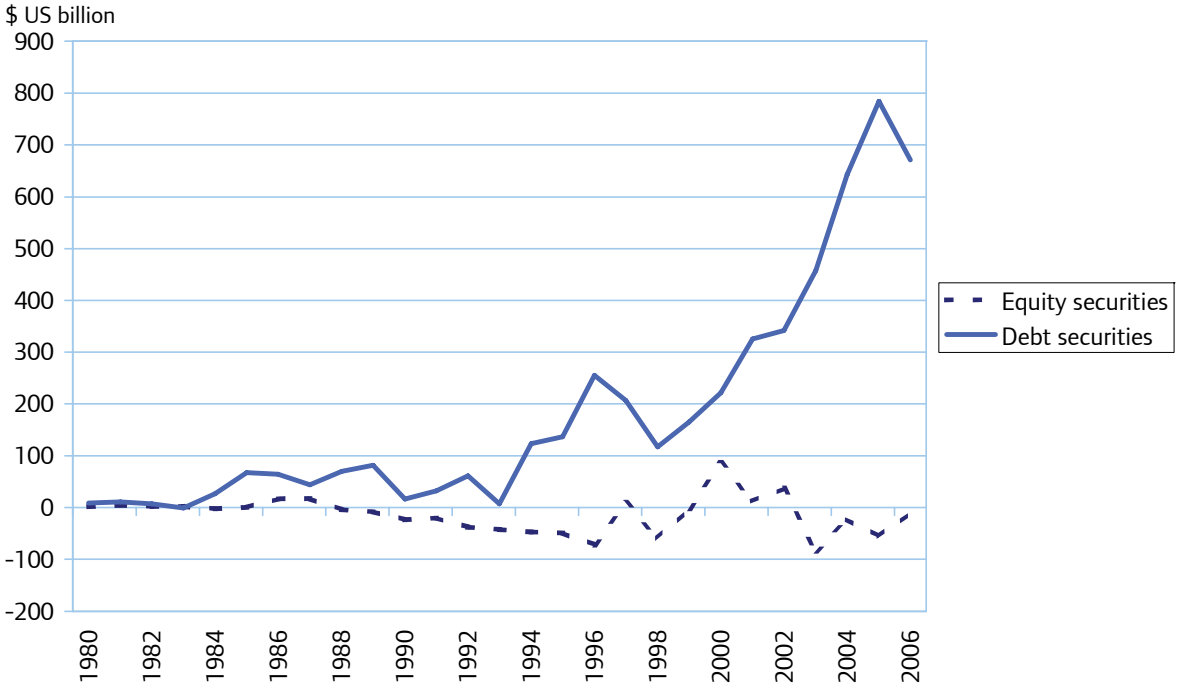
Figure 10: US International investment position, net foreign asset (stocks), 1980-2006



Source: Ecowin and International Financial Statistics from IMF.

At the end of 2006, US net foreign debt amounted to more than $4 trillion (about 40 per cent of GDP) with the interest burden owed to foreign lenders ever-growing[14].

Figure 11: Breakdown of US portfolio investment, 1980-2006



Source: Ecowin and International Financial Statistics from IMF.

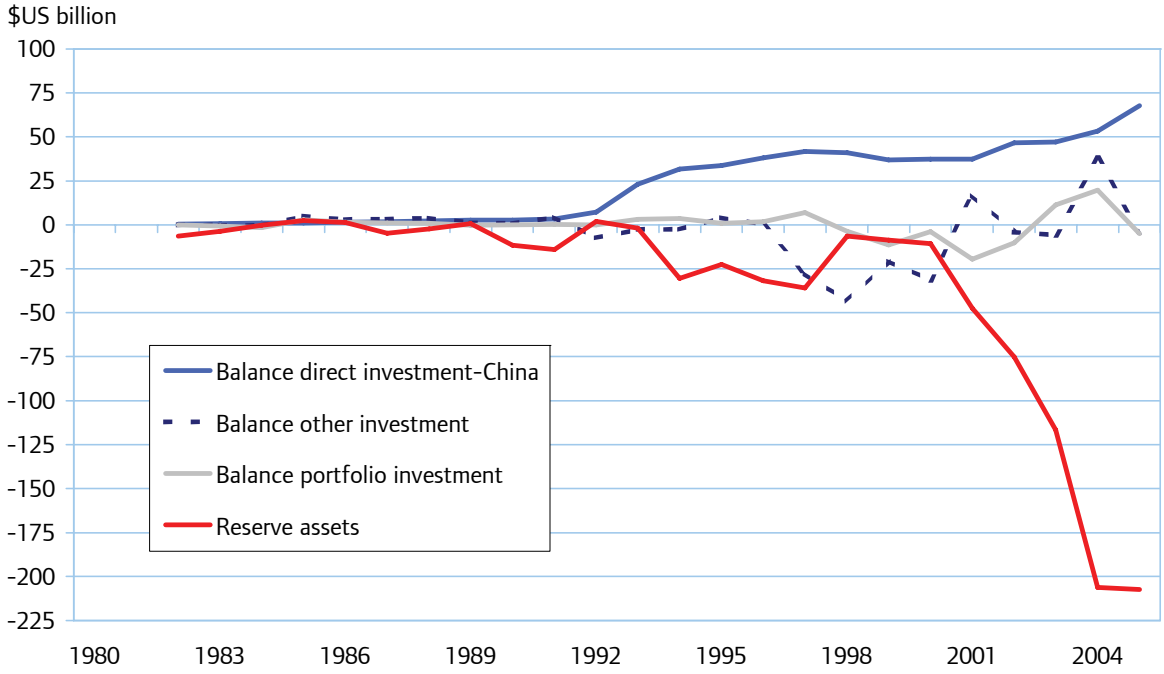
[14] Testimony of Chairman Ben S. Bernanke: Outlook for the US economy, April 2006.

The increase in the US portfolio investment component has been totally attributed to the rise in investment in debt securities (consisting of US bonds, notes and money market instruments) – see Figure 11. However it remains to be seen whether or not world economies' enthusiasm to hold US money market instruments will continue unabated following the fallout in the sub-prime mortgage market. Early signs of its impact are visible, in particular, among close trading partners such as the UK[15]. Ernst and Young ITEM club[16] has suggested that the broad impact of the credit crunch for the UK could be in the order of reducing GDP growth by around 1 per cent for both 2008 and 2009.

Mirroring the US: China

Since 2000 the Chinese government has been accumulating US bonds and money market instruments as evidenced in Figure 12 by negative holdings in their reserve assets, which means they have accumulated reserves abroad in 2005 (most of which is denominated in US dollars). This is mainly driven in large part to limit the appreciation of their exchange rate, enabling them to increase their share of exports to the rest of the world.[17]

Figure 12: China's capital account components, net flows, 1980-2006



Source: Ecowin and International Financial Statistics from IMF.

However it is important to note that large portfolio investments in the US do not necessarily represent a strong capital position for China. China's financial system remains relatively undeveloped and its capital account remains closed. It has been argued that exchange

[15] The Bank of England's recently published 'Credit Conditions Survey' highlights the potential negative impact the credit crunch will have on the UK's corporate sector and its investment decisions.
[16] ITEM (Independent Treasury Economic Model) Club Special Report, September 2007.
[17] Bank of England (2005). *Financial Stability Review*. December 2005.

controls limit the ability of residents to freely convert the Yuan into foreign currencies, capital controls limit investment options and the bulk of household savings are in the form of low-yielding deposits at state-owned banks[18].

Despite its relative healthy current account balance as demonstrated in the balance of payments in Table 8 (current account balance + capital account balance = balance of payments), China's capital account balance remains comparable to that of the UK and less than one-twelfth the size of the US capital account balance.

Table 8: Summing up – balance of payments compared

Balance of payments, IMF series 2005, ($ bn)			
	US	**China**	**UK**
Current account balance	-791.5	160.8	-53.4
Capital account balance	767.0	62.9	60.9
Net errors & omissions	10.4	-16.4	-5.8
Overall balance	***-14.1***	***207.3***	***1.7***

Source: IMF, International Financial Statistics.

[18] Dorn, J. (2006).

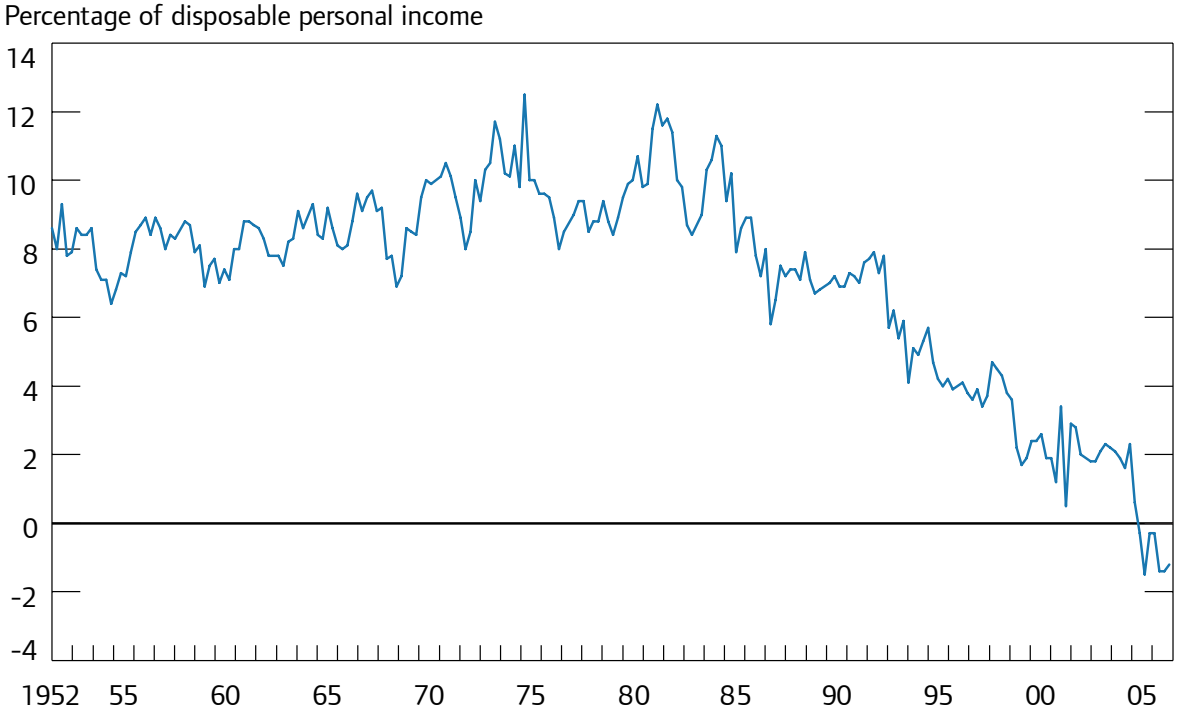
3. Explanations for global imbalances

3.1 The consumption boom hypothesis

Two widely accepted schools of thought have emerged to explain the large and persistent US current account deficit. The first relates to international trade – more specifically excessive consumption on behalf of the US (the *consumption boom* hypothesis). This foremost of explanations contends that US consumers have shifted their preferences from saving for the future (near zero personal savings rate) toward purchasing more consumption goods in the present. The surge in demand for domestic consumption goods requires a corresponding increase in imported consumption goods. This theory implies that there has been excessive borrowing from abroad to finance a domestic consumption binge.

US private consumption growth has been strong since the early 1990s due to the boom in equity prices, a reduction in personal savings and rising levels of consumer debt. The late 1990s and early 2000s were characterised by an unparalleled global equity market boom and asset price bubbles (stock, housing, and exchange markets) led by Americans favouring private consumption over lower savings. Figure 13 shows how the US personal savings rate has recently fallen into negative territory.

Figure 13: US personal savings rate (per cent of disposable personal income, 1952-2006)



Source: Steindel (2007).

The US personal savings rate, which had been stable at around 10 per cent of disposable personal income until 1985, has steadily declined since 1985 to -1.1 per cent in 2006[19]. US mortgage debt has also risen considerably over the same period. In this instance it seems apparent that an increase in interest rates to encourage greater saving as opposed to spending would be a logical remedy, yet given current circumstances (a weakening US economy, credit crunch and sub-prime mortgage market fallout), the Federal Reserve are more inclined to cut interest rates to stimulate growth. As seen in Figure 14, US interest rates were at very low levels between 2002 and 2005. Indeed US interest rates have been at relatively low levels since the beginning of the 1990s – the period over which the savings rate has seen its greatest fall.

Figure 14: US interest rates (per cent), 1980-2007

Source: Ecowin

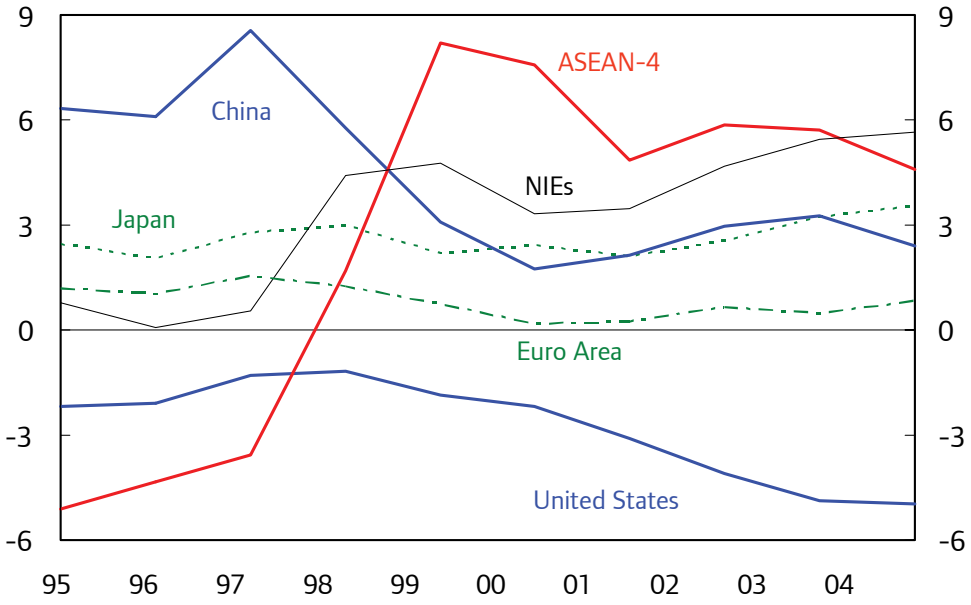
3.2 The global saving glut hypothesis

The second related rationale is on saving, investment, and international capital flows – more specifically how low real global interest rates (contributing to the US current account deficit by fuelling consumption in the US) are a result of excessive savings in emerging economies. This *global saving glut* hypothesis reflects a shift that has transformed those economies (mainly in Asia) from borrowers on international capital markets to large net lenders. With the onset of the Asian financial crisis of 1997, there was a flight of foreign capital and savings into the US with emerging economies accumulating large US dollar denominated reserves. This acted as a buffer against potential capital outflows and prevented exchange rate appreciation which harms export-led growth.

[19] Steindel (2007).

Amongst the ASEAN-4, the increased current account surpluses result from a marked drop in investment, largely a reaction to the excessive investment prior to the 1997 crisis (see Figure 15). By contrast, the savings rate did not change much in these countries so they started running large surpluses.

Figure 15: Gross national saving minus investment (in per cent of GDP), 1995-2004



Note: NIE = Newly Industrialising Economies. ASEAN-4 = Association of Southeast Asian Nations of Indonesia, Malaysia, Philippines and Thailand. Source: Rajan (2005)

The willingness of Asian central banks to accumulate enormous amounts of US dollar denominated reserve assets is a consequence of their relatively closed capital accounts (e.g. China), the need to stabilise[20] (or as some commentators believe undervalue[21]) their exchange rates and the need to insure against sudden shifts in capital flows such as those seen in 1997. The US Bureau of Economic Analysis estimates that China and Japan alone hold about two-thirds of global US dollar reserves ($2.3 trillion).

From 1985 to 2005, foreigners acquired almost 75 per cent of the overall increase in outstanding US treasuries. From 1995 to 2005, domestic holdings actually fell while foreign holdings grew by twice the aggregate increase[22]. And although the flight of foreign capital into the US has enabled the country to run large budget deficits without having to endure higher interest rates (the US is particularly sensitive to rises in interest rates due to its massive foreign debt), the US seems to be excessively dependent on foreigners to finance the domestic economy by buying dollar assets — US bonds, stocks or property.

[20] Pegged exchange rates and resistance to pressures for revaluation as their economies and current accounts strengthen have been at the centre of many emerging market development strategies.

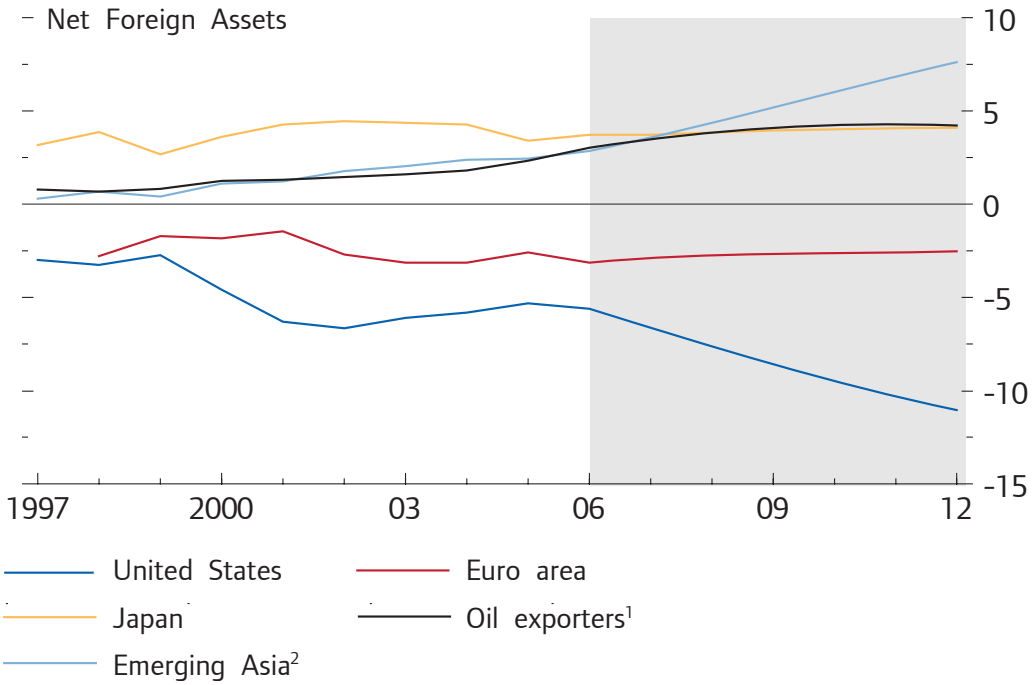
[21] Often countries compete through under-valued currencies that confer an exchange rate subsidy rather than competing on productivity. If a country's economy is overheating at the same time that it has a bigger current account surplus (or a smaller current account deficit) than is needed to maintain a sustainable balance of payments position for the foreseeable future, then its currency is undervalued. If the economy is underemployed and it is losing reserves because of a current account deficit larger than can be financed by sustainable capital inflows, then its currency is overvalued.

[22] Bergsten and Truman (2007).

4. The problem: the sustainability of global imbalances and its implications

The financial sustainability of large and persistent deficits (e.g. US) and surpluses (e.g. China) essentially relies on the willingness of foreign investors to continue accumulating net claims on the US. The US accounts for over 75 per cent of global deficits[23].

Figure 16: Actual and Projected Net Foreign Assets (per cent of world GDP)



Note: [1]Algeria, Angola, Azerbaijan, Bahrain, Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Syria, Turkmenistan, UAE, Venezuela and Yemen.
[2]China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.
Source: IMF World Economic Outlook *2007.*

As seen in Figure 16 the IMF expects net claims on the US to increase over time. By 2012, US net foreign liabilities will equate to roughly 11 per cent of the global economy.

Arithmetically, the current pattern of global imbalances seems unsustainable. For instance if US GDP continues to grow at an average of 5 per cent a year and the current account deficit of 6-7½ per cent of GDP remains at this level, then this will mean that the US economy will reach a net external debt to GDP ratio of 100-150 per cent.[24] Debt of this magnitude questions the US's ability to repay.

[23] Obstfeld, M. and Rogoff, K. (2005).
[24] Eichengreen, B. (2006).

4.1 Two possible scenarios and their implications for global imbalances[25]

Scenario a) A permanent increase in real oil prices of $10 US per barrel
The impact on the world economy depends on which countries import and which countries export oil:

For *fuel importers*, the rise in world oil prices worsens the trade balance, leading to a higher current account deficit and a deteriorating net foreign asset position. Higher oil prices decrease private disposable income and corporate profitability, reducing domestic demand; along with a depreciation of the exchange rate, this acts to bring the current account back into equilibrium over time. The speed and output cost of adjustment depends on factors such as the degree of trade openness, structural flexibility, and central bank credibility, as well as the shock's expected persistence and the speed with which it is allowed to feed through into domestic fuel prices. Among other things, these determine the extent to which rising oil prices raise inflationary pressures, necessitating a monetary tightening that could lead to slower growth.

For *fuel exporters*, the process works in reverse: they get richer. A permanent $10 per barrel of oil price increase boosts the net foreign asset position of oil exporters by about 2 per cent of GDP for around three years. One important difference, however, is that fuel exporters may take longer than fuel importers to adjust to the increase in fuel prices. Hence, their savings may remain at high levels for extended periods. Consequently, aggregate global demand is likely to fall. In turn, this sets in train a process of multilateral adjustment, driven by interest and exchange rate changes, as well as growth differentials. The incipient excess of global saving over investment puts downward pressure on real interest rates, which supports investment demand in fuel importers and weakens incentives to save in fuel exporters.

Scenario b) Appreciation of Asian currencies (including the Yuan)
Over the past decade many Asian countries have followed export-led growth strategies. In 2004, 46 per cent of East Asia's exports went to the US. It has been hypothesised that China and the US enjoy a mutual convenient relationship whereby China exports cheap consumer and producer goods to the US. Some commentators believe that this situation could continue for years.

The IMF have already considered a scenario in which the Chinese Yuan appreciates by 10 per cent in the first round and other Asian currencies appreciate by 5 per cent in the next round. The estimated impact for Asia as a whole is a decline in GDP growth by nearly 0.5 percentage points and a narrowing of the current account balance by 1/3 per cent of GDP (about $32 billion). In China alone the current account balance would decline by almost $12 billion.

[25] IMF (2006). *World Economic Outlook*, Chapter II, IMF Report.

4.2 Implications of global imbalances

A clear implication is that global current account adjustment should prioritise the improvement of the US current account (via its trade balance) rather than its capital account (international investment position). There are two mechanisms which will enable this. Firstly, what is needed are movements in exchange rates where the demand for foreign exchange shifts from net borrowers such as the US to net lenders such as Japan (a significant depreciation in the dollar and corresponding appreciations in other key currencies). Secondly, movements in interest rates are important to rebalance demand and saving between the US and Asia and across the globe. The savings-investment analysis in Section 3 suggests we need greater savings in the US, higher investment in the Asian economies, and greater consumption in China to narrow the imbalances. What isn't clear though is whether or not adjustment should take place gradually to minimise disruption or rapidly to reduce future risk of a sudden and abrupt unplanned correction in the US current account deficit.

With the US economy currently operating close to full employment, adjustment requires a rate of growth in US domestic demand below that of output to prevent inflationary excess demand. A rebalancing of world demand between the US and Asia is central to this and the demand for foreign exchange will need to shift from net borrowers such as the US to net lenders such as Japan. This implies that Asian currencies appreciate[26] (accumulate new US dollar reserves at a slower pace and allow domestic consumption to drive more growth), that Asian economies diversify their reserve currencies and that the US dollar depreciates.

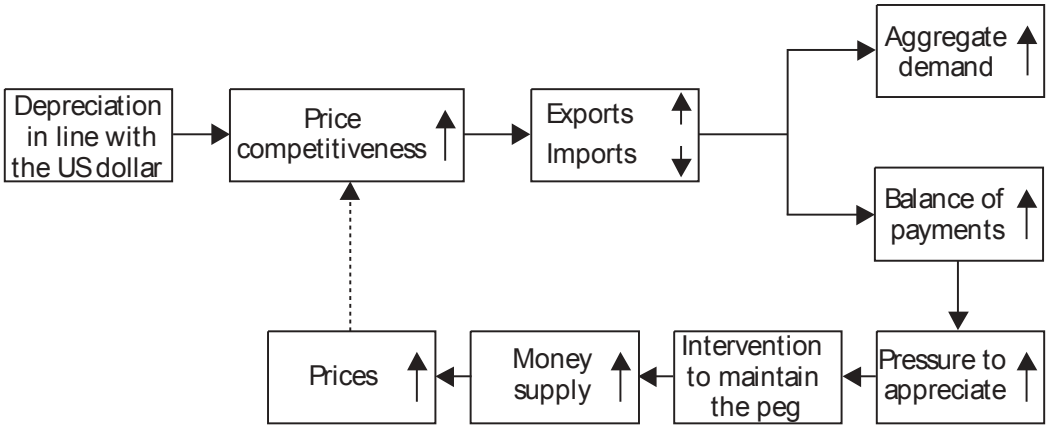
On the one hand, a falling US dollar benefits the US and is a good way to re-balance the world economy because it makes US exports cheaper, boosting aggregate demand for its products thus reducing the current account deficit. This also applies to economies whose currencies are pegged[27] to the US dollar as they depreciate in line with the dollar – see Figure 17 (China maintains a de facto peg to the dollar). The opposite (worsening current account and output growth) is more likely to be true for countries with floating exchange rates, as their currencies will appreciate with a depreciating US dollar[28].

[26] Bank of England (2005). *Financial Stability Review*, December 2005.

[27] The exchange rate is fixed to the dollar, meaning authorities are obliged to buy dollars to prevent their own currencies from rising.

[28] There are a few factors that complicate this relationship – the first is that for exchange rates to affect trade balances, export and import demand has to be responsive to price changes, as prescribed by the Marshall-Lerner condition. Secondly, that there can be substantial lags between exchange rate movements and changes in trade balances.

Figure 17: Macroeconomic Impact of Exchange Rate Depreciation under a Pegged Exchange Rate Arrangement



Source: Fan (2002).

However floating exchange rate regimes are less likely to suffer from rising inflation and they allow for a more flexible interest-rate system than US dollar pegged currencies[29].

One model finds that a real effective depreciation of the US dollar of between 10 and 20 per cent from the current level is needed to shrink the US current account deficit to 3 per cent of GDP over the next three years[30]. Others believe that it makes little sense to ask how much US dollar depreciation is needed to reduce the current account deficit since exchange rates and current account balances are jointly determined endogenous variables (inherently related to one another)[31].

On the other hand, a falling US dollar is bad for the US and the world economy because it generates anxiety as investors in US dollar-denominated securities may think that no policies are in place to stop the worsening of the US current account deficit. If investors believe that the US dollar will continue to devalue unabated, they will start selling dollar assets (a 'run' on the dollar)[32]. Such reversals can be highly disruptive to the US because private consumption, investment, and government expenditure must be curtailed when foreign financing is no longer available. A sudden reallocation of portfolios away from US dollar-denominated assets, or even just a gradual decline in the demand of US dollars as a reserve currency would entail significant costs as the value of these assets falls[33].

[29] Recent speculation surrounds whether or not Gulf States will ditch their currencies' pegs against the US dollar due to rising inflationary pressures.
[30] Aherne, Cline, Lee, Park, Pisani-Ferry and Williamson (2007).
[31] Obstfeld, M. & Rogoff, K. (2005).
[32] Given that US capital markets are so large and liquid, a more likely scenario would be foreign shifts from treasuries to other US dollar investments, accommodated by a reallocation of the portfolios of other investors.
[33] Eichengreen, B. (2006).

Should the US dollar continue an extended decline, under pressure from unprecedented high trade deficits, there is every reason to believe that central banks and foreign private investors may seek greater diversification in their reserves, most likely into euros (e.g. last year the Swedish Central Bank cut the proportion of its US dollar reserves from 37 per cent to 20 per cent, while raising its Euro holdings from 37 per cent to 50 per cent)[34]. Moreover based on a survey of central banks in Asia, recent research from Greenwich Associates shows that the US dollar has lost its status as the pre-eminent currency for fixed-income products such as corporate bonds in Asia[35].

Figure 18: The US dollar against the Euro and Pound Sterling (1997-2007)

Source: Reuters Ecowin.

A long-term decline in the value of the US dollar (the dollar has already fallen 41 per cent against the Euro since 2002 – see Figure 18) could precipitate some form of foreign exchange crisis. In this instance, countries that have purchased US assets are likely to see a capital loss on those assets, both on account of currency valuation and on account of lower prices on assets with fixed interest coupons. If Japan and China[36] (first and second largest holders of US Treasury debt respectively) were to sell their hoard of US Treasury debt, US interest rates would soar as a massive sale would immediately drive down bond values, raising not only the effective interest rate on existing bonds but also the market into which new bonds are sold.

[34] Belkas, T. (2006).
[35] Tett, G. (2007).
[36] At the World Economic Forum in January, 2005, Fan Gang, Director of the National Economic Research Institute in Beijing recommended that China sell its US Treasury debt because interest rates were too low.

Historically, the rise and fall of major currencies is a normal cyclical trend and the US dollar has survived slides before, as in the late 1970s and mid-1980s (in 1985-87, the dollar fell by 54 per cent against the Deutschmark)[37]. Yet, of greater concern is if stagnation and inflation occur simultaneously (stagflation), since fiscal policy and monetary policy will only offer trade offs between growth and inflation. The Federal Reserve can either slow growth to reduce inflationary pressures by limiting money supply through interest rate hikes, or it can allow increases in price to occur and increase money supply (by creating government debt through the issuance of bonds and then loaning the money to commercial banks at low interest rates) at the risk of creating inflation in order to stimulate growth.

If depreciating US dollar assets in the world's currency reserves, on top of a credit crunch and a weakening economy, is not reason enough for central banks and private investors to reduce their US dollar holdings then the growing popularity of the Euro, might be. Euro bonds present a viable alternative to US dollar assets for many investors (global holdings of Eurobonds are currently growing faster than US dollar bonds). Table 9 shows how the Eurozone's size and depth of capital markets make it an ideal reserve currency and an immediate rival to the dollar.

Table 9: Reserve rivals (Dollar and Euro compared)

2007	United States	Euro Area
GDP, $trn	11.6	9.5
Foreign exchange market turnover, % of total	43.0 (in $)	18.5 (in euros)
Stock market value, $trn	15.6	13.7
Currency in circulation, $bn	821	895

Source: Losing Faith in the Greenback. *The Economist November 29 2007*.

Nevertheless, for the time being the largest creditors in Japan and China are the *least* likely sources of financial market disruption as they have little interest in seeing the value of their own existing US dollar reserves plunge. The interdependent[38] nature of the global economy means that as long as the US is the world's largest economy, a plunging US dollar will signal the G7 and China to collectively intervene in currency markets and buy dollars to protect their dollar holdings and re-balance the world economy.

4.3 Global imbalances and London

If global adjustment should take place then the main area of concern for the UK is how the movement in exchange rates will impact on its exports. For example a weak US dollar puts US firms at a competitive edge over UK firms by making US exports cheaper. Coupled with this, a sliding US dollar against sterling lowers tourist receipts as the UK and London (which attracts roughly 50 per cent of all tourists to the UK) becomes an increasingly expensive destination for US visitors.

[37] Between 1978 and 1980 the Treasury sold $6.4 billion of "Carter bonds", mostly denominated in Deutschmarks to raise funds to defend the US dollar.

[38] China's Central Bank recently estimated that every 1 per cent drop in US economic growth translates into a 6 per cent fall in Chinese exports (the US receives a fifth of all Chinese exports making it the second largest destination for Chinese made goods after the EU). Anderlini (2007).

For London, a weak US dollar poses the same challenges, but also opportunities since the city is home to numerous large US financial and business service corporations where London is a key foreign currency revenue base. Nevertheless, a falling US dollar and a slowdown in the US economy is a threat to London's economy. Given London's reliance on US firms as large employers in the financial district, any slowdown may result in redundancies which would have negative knock-on effects for a range of businesses from legal firms and accountancies to support services such as convenience stores, security and cleaning firms etc. Redundancies are also likely to adversely affect house prices and generally weaken consumer demand for goods (including luxury goods) and services across London's economy. It is apparent that London needs to remain competitive and reputable in this sector – the recent downgrades to credit-related securities, once considered excellent investments, have damaged the reputation of US capital markets.

An assessment of global economic developments reveals that emerging markets present huge opportunities for London. From earlier discussion we have seen that UK transactions with China have grown the fastest of any trading partner (exports to China grew £4.4 bn (365 per cent) and imports from China grew £14.2 bn (560 per cent) between 1996 and 2006). The fact that China's capital controls limit investment options and the bulk of household savings is in the form of low-yielding deposits at state-owned banks, creates strategic opportunities for London's competitive financial institutions. China's need to invest in future growth offers opportunities for London's firms and talent to provide what it does best - corporate finance and business services and related activities such as accountancy, legal support and system architecture. Eight Chinese companies have already set up their European headquarters in London since April last year and 56 Chinese firms are already listed on London's Alternative Investment Market (AIM)[39].

There are also other areas of strength that have attracted substantial international interest. India's appetite for London's expertise in information technology, internet and e-commerce, pharmaceutical and biotechnology sectors is growing. India is now London's second largest foreign investor after the US (in 2006, 27 Indian companies located in London)[40]. India's interest reflects London's dynamism and specialisms – qualities of which put London in a strong position to harness trade and investment opportunities and weather disruptive cycles such as the credit crisis which is presently unfolding.

[39] Think London.
[40] Ernest & Young. *European Investment Monitor*.

5. Conclusions

The causes and implications of global imbalances have become an increasingly controversial subject in recent years with ever greater polarisation between the largest creditor China and the largest debtor the US with a current account deficit worth $857 bn in 2006 (6.5 per cent of its GDP). On the flipside, the US like the UK registers a capital account surplus which counterbalances its current account deficits. Behind the UK's capital surplus lies London with its innovative, lucrative and heavy services export orientation.

Emerging giants such as China and India provide huge export opportunities for London. Consumers in these countries will look to import high value added services not offered in their own countries, for example, specialist financial services on offer in London. Given China's closed capital account and its consequences e.g. massive nonperforming loans, poor performance of stock markets, undervalued real exchange rate etc., pressure to liberalise the capital account is growing. If state-owned banks are privatised, exchange rate and capital controls removed, this will usher in huge opportunities for London's financial sector.

Despite facing stubbornly high oil prices, a struggling housing market and weaker growth, the US maintains credit worthiness and its position as the world's premier economy. Arguably the current weak US dollar is a natural adjustment mechanism to boost US exports and correct imbalances, especially when domestic spending may be hit by the credit squeeze and sub-prime crisis. Moreover a weak dollar means that for America's largest (and some of the world's largest) financial corporations locating in London provides a strategic, expanding (foreign currency) revenue base. Though whether or not and for how long exchange rate movements can be used to avert a crisis of confidence (especially if a US recession is on the horizon) is highly questionable and rests heavily on the opinions of financiers and policymakers worldwide.

Clearly the future brings considerable challenges to the US and the world's ability to re-balance. If China reforms its financial system and becomes the world's largest economy, the US government will find it hard to sustain a current account that has for years been financing consumption rather than investment, with money coming increasingly from debt rather than equity. Willingness to fund US borrowing will wane as the US becomes a smaller part of the global economy and countries like China become a larger part.

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Appendix 1. IMF description of countries within different regions

North America:
US
Canada

Developing Asia:
Afghanistan
Bangladesh
Bhutan
Brunei Darussalam
Cambodia
China
Fiji
India
Indonesia
Kiribati
Lao Republic
Malaysia
Maldives
Myanmar
Nepal
Pakistan
Papua Guinea
Philippines
Samoa
Solomon Islands
Sri Lanka
Thailand
Tonga
Vanuatu
Vietnam

Africa:
Algeria
Angola
Benin
Botswana
Burkino Faso
Burundi
Cameroon
Cape Verde
Central African Republic
Chad
Comoros

Congo, Democratic Republic
Ivory Coast
Djibouti
Equatorial Guinea
Eritrea
Ethiopia
Gabon
Gambia
Ghana
Guinea
Guinea-Bissau
Kenya
Lesotho
Liberia
Madagascar
Malawi
Mali
Mauritania
Mauritius
Morocco
Mozambique
Namibia
Niger
Nigeria
Rwanda
Sao Tome and Principe
Senegal
Seychelles
Sierra Leone
Somalia
South Africa
Sudan
Swaziland
Tanzania
Togo
Tunisia
Uganda
Zambia
Zimbabwe

Advanced economies, Asia:
Japan
Hong Kong
Singapore
South Korea
Taiwan

Industrialised countries:
Australia
New Zealand

Central and Eastern Europe:
Albania
Bosnia & Herzegovina
Bulgaria
Croatia
Czech Republic
Czechoslovakia
Estonia
Hungary
Latvia
Lithuania
Macedonia, FYR
Malta
Poland
Romania
Serbia and Montenegro
Slovak Republic
Slovenia
Turkey

Western Hemisphere:
Anguilla
Antigua and Barbuda
Argentina
Aruba
Bahamas, The
Barbados
Belize
Bolivia
Brazil
Chile
Colombia
Costa Rica
Dominica
Dominican Republic
Ecuador
El Salvador
Grenada
Guatemala
Guyana

Haiti
Honduras
Jamaica
Mexico
Montserrat
Netherlands Antilles
Nicaragua
Panama
Paraguay
Peru
St. Kitts and Nevis
St. Lucia
St. Vincent & Grenadines
Suriname
Trinidad and Tobago
Uruguay
Venezuela, Rep.

Middle East:
Bahrain, Kingdom of
Egypt
Iran, I.R. of
Iraq
Jordan
Kuwait
Lebanon
Libya
Oman
Saudi Arabia
Syrian Arab Republic
United Arab Emirates
West Bank and Gaza
Yemen, Republic of

Advanced economies, Europe and other:
Austria
Belgium
Denmark
Finland
France
Germany
Greece
Iceland
Ireland
Italy
Luxembourg

Netherlands
Norway
Portugal
Spain
Sweden
Switzerland
United Kingdom

Faroe Islands

Common Independent States:
Armenia
Azerbaijan
Belarus
Georgia
Kazakhstan
Kyrgyz Republic
Moldova
Mongolia
Russia
Tajikistan
Turkmenistan
Ukraine
Uzbekistan

Appendix 2: Defining the capital account

Composition of the capital account

The capital account captures how net lending or borrowing is achieved by capital transactions between residents and foreigners in a given country. It has four main components depending on the type of investment. The primary basis for classification of the capital account is functional into:

1. Direct investment
2. Portfolio investment
3. Other investment (including loans)
4. Derivatives
5. Reserve assets (balancing term in the balance of payments and error and omissions)

Transactions in the above categories (1) - (4) are generally recorded for those investing in the resident country (liabilities) and residents holding foreign claims (assets). The IMF Manual of the Balance of Payments explains that the transactions for (1) - (4), transactions are recorded as credit and debits for assets and liabilities sides and presented as net balances, i.e. net credits minus net debits. The IMF has the convention to report net debits with a negative sign. So, the net balance of purchases of physical or capital assets are given by net credit plus net debits.

Net purchases of foreign assets (direct investment, or portfolio investment or in other investment to the resident) by the resident country represent a capital outflow. Whereas, net purchases of resident assets by foreigners represent a capital inflow.

When the net balance in the capital account is in surplus (positive), the resident country is having more capital inflows than outflows, and it is net borrowing. A deficit in the capital account (negative) in the resident country means that capital inflows are lower than the outflows, and it is net lending.

International investment position (stocks)

The international investment position (IIP) measures the levels of capital investment of a given country and the rest of the world. It represents a balance sheet of stocks of external assets and liabilities. This is also referred to as the net foreign asset position of a given country.

The coverage of various components of IIP is similar to those corresponding components of the capital account of the balance of payments but measured as stocks. The IIP also includes the effects of changes in asset prices, exchange rates and other adjustments.

Breakdown of the capital account

1) Capital transfers and acquisition/disposal of non-produced, non-capital assets

2) a. Direct investment Abroad

- Equity capital
- Reinvested earnings
- Other capital

b. Direct investment in the country resident

- Equity capital
- Reinvested earnings
- Other capital

3) Portfolio investment

Assets

- Equity securities
- Debt securities

Liabilities

- Equity securities
- Debt securities

4) Derivatives (net)

5) Other investment

Assets

- Trade credits
- Loans
- Currency and deposits
- Other assets

Liabilities

- Trade credits
- Loans
- Currency and deposits
- Other liabilities

6) Reserve assets

- Monetary gold
- Special drawing rights
- Reserve position in the IMF
- Foreign exchange

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Chinese

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Vietnamese

Nếu bạn muốn có văn bản tài liệu
này bằng ngôn ngữ của mình, hãy
liên hệ theo số điện thoại hoặc địa
chỉ dưới đây.

Greek

Αν θέλετε να αποκτήσετε αντίγραφο του παρόντος εγγράφου στη δική σας γλώσσα, παρακαλείστε να επικοινωνήσετε τηλεφωνικά στον αριθμό αυτό ή ταχυδρομικά στην παρακάτω διεύθυνση.

Turkish

Bu belgenin kendi dilinizde
hazırlanmış bir nüshasını
edinmek için, lütfen aşağıdaki
telefon numarasını arayınız
veya adrese başvurunuz.

Punjabi

ਜੇ ਤੁਹਾਨੂੰ ਇਸ ਦਸਤਾਵੇਜ਼ ਦੀ ਕਾਪੀ ਤੁਹਾਡੀ ਆਪਣੀ ਭਾਸ਼ਾ ਵਿਚ ਚਾਹੀਦੀ ਹੈ, ਤਾਂ ਹੇਠ ਲਿਖੇ ਨੰਬਰ 'ਤੇ ਫ਼ੋਨ ਕਰੋ ਜਾਂ ਹੇਠ ਲਿਖੇ ਪਤੇ 'ਤੇ ਰਾਬਤਾ ਕਰੋ:

Hindi

यदि आप इस दस्तावेज की प्रति अपनी
भाषा में चाहते हैं, तो कृपया निम्नलिखित
नंबर पर फोन करें अथवा नीचे दिये गये
पते पर संपर्क करें

Bengali

আপনি যদি আপনার ভাষায় এই দলিলের প্রতিলিপি
(কপি) চান, তা হলে নীচের ফোন্ নম্বরে
বা ঠিকানায় অনুগ্রহ করে যোগাযোগ করুন।

Urdu

اگر آپ اِس دستاویز کی نقل اپنی زبان میں
چاھتے ھیں، تو براہ کرم نیچے دئے گئے نمبر
پر فون کریں یا دیئے گئے پتے پر رابطہ کریں

Arabic

إذا أردت نسخة من هذه الوثيقة بلغتك، يرجى
الاتصال برقم الهاتف أو مراسلة العنوان
أدناه

Gujarati

જો તમને આ દસ્તાવેજની નકલ તમારી ભાષામાં
જોઈતી હોય તો, કૃપા કરી આપેલ નંબર ઉપર
ફોન કરો અથવા નીચેના સરનામે સંપર્ક સાધો.