

Global Imbalance: a Policy Mishap or a Rational Outcome? The Case of Korea

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Among multitude of issues, global imbalance has attracted more attention than may be warranted because it is perceived to be policy induced and constrain global growth, or a zero sum game in the sense of growing at another countries' expense. Yet many of those with a current account surplus face a rapidly aging population that motivates high savings to ensure consumption smoothing. Those with a deficit, on the other hand, may need to be there for the opposite reason. Thus, a current account imbalance could be a rational market outcome, rather than a policy induced market distortion. If so, global imbalance should be welcomed. Also, a transitional imbalance due to exogenous shocks such as oil price decline should best be left to the market to find its own speed and path to a new equilibrium.

Another important factor underlying the imbalance, recently found in emerging markets, is the decline in household income share. Household savings fell as it takes longer to adjust consumption in response to falling income. Total savings, however, rose marginally as strong corporate savings are more than compensated for the decline in private savings. In sum, savings and investment gap widened with corporate investment falling in response to a weak private consumption outlook. Unless this trend is reversed, corporate profit will also start to decline, potentially starting a downward spiral. Thus, global imbalance is a serious concern also in these surplus countries, except their concern is a very different one from those often debated at the global fore.

Aging and Current Account Imbalance

According to the UN population projection,¹ aging will not become a problem at the global level until a few decades later. However, this is not true for several individual countries, especially in those countries that have so far played a key role in providing the growth momentum. These countries include most of the advanced countries and some emerging markets such as China.

As elaborated in Lee *et al.* (2013),² national savings will tend to increase when the dependency ratio is low as countries will make sure that they have enough savings when they retire. In a rapidly aging society, using the savings for investment in its own country will raise income permanently, but later as the size of the working population starts to shrink, more people will become dependent on a smaller amount of income, and thus consumption will fall. Investment in another country, however, will help smooth consumption as its contemporaneous income will not increase but instead it will receive the return when its population starts to shrink.³ The country with higher dependency ratio borrows from the country with low dependency ratio for investment, and then later the borrowing reverses of which the pace is determined by the population profile.

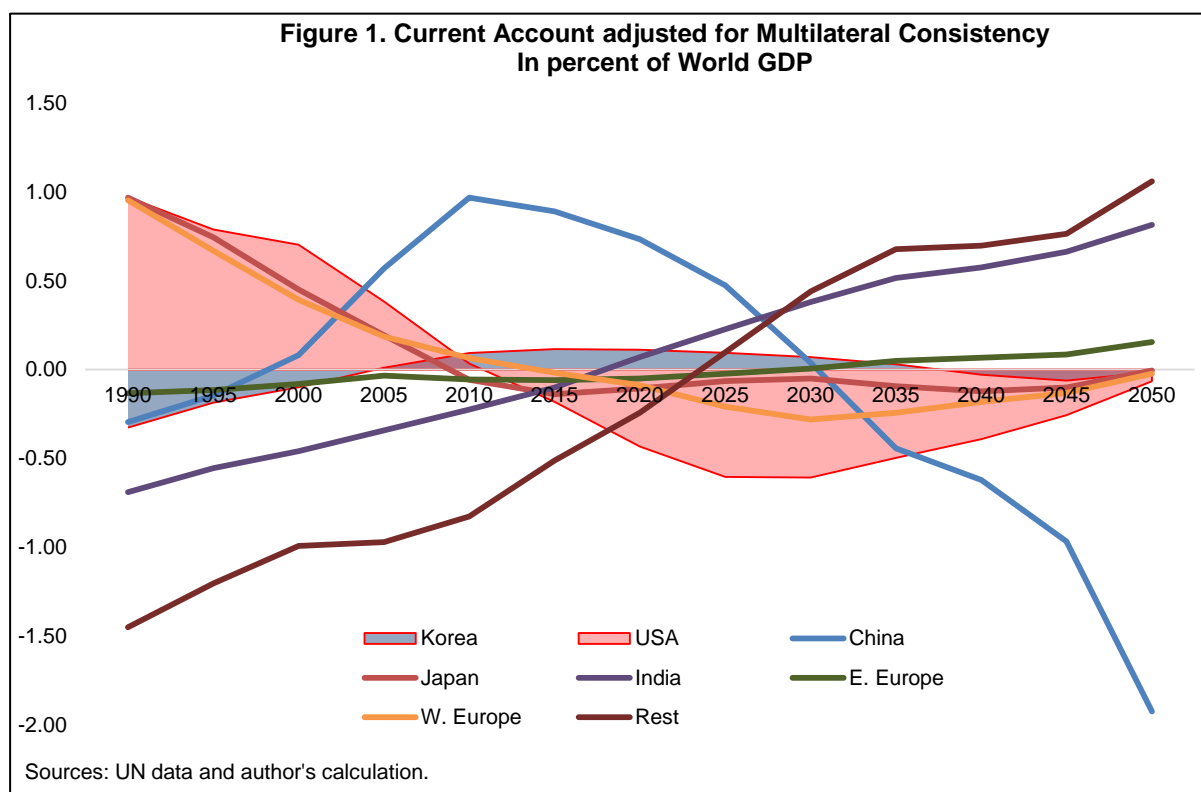
While in reality one has to factor in the discount rate, transactions costs, risks, cross border differences in marginal conditions, and the myopic nature of many individuals, population dynamics could exert large influence on the S-I balance. This is particularly true if the aging is imminent and expected to take place rapidly. While one cannot rely on a social planner to optimally allocate investment between domestic and foreign markets, population profile should at least give a broad sense of how current account balance in different countries should evolve to ensure consumption smoothing.

This report uses same approach as in Lee *et al.* (2013) to calculate the “population-consistent current account” balance (PCCA) adjusted for multilateral consistency of major groups and countries, including Korea and the remaining countries lumped into “Rest”. It uses a longer time horizon (1980-2070) than in Lee *et al.* (2013), and 5-year intervals to reduce noise. For projection, UN’s medium fertility assumption is used. The calculation (Figure 1) indicates the following:

¹ United Nations, Department of Economic and Social Affairs, Population Division (2013), *World Population Prospects: The 2012 Revision*, DVD Edition.

² I Lee, X Qingjun and M Syed (2013), “China’s Demography and its Implications,” IMF Working Paper No. 13/82.

³ This of course assumes that investment returns are not repatriated instantaneously.



- China's current account surplus should have peaked in 2010, and from then on it should have continued to decline until around 2030 from whence it should become a net borrower.
- The United States' current account balance should have been a surplus until 2010, and then should bottom out at around 2030.
- Western Europe⁴ and Japan should follow broadly the same pattern as that of the United States, but their borrowing requirements should be much smaller.
- Korea should follow China's pattern although the peak should come somewhat later in 2015; the scale relative to global GDP is much smaller reflecting the country size.
- India, Eastern European countries⁵, and the rest of the world should be net borrowers of savings until 2015 (in the case of India), and 2025 (for the rest of the world) and then revert as supplier of savings.

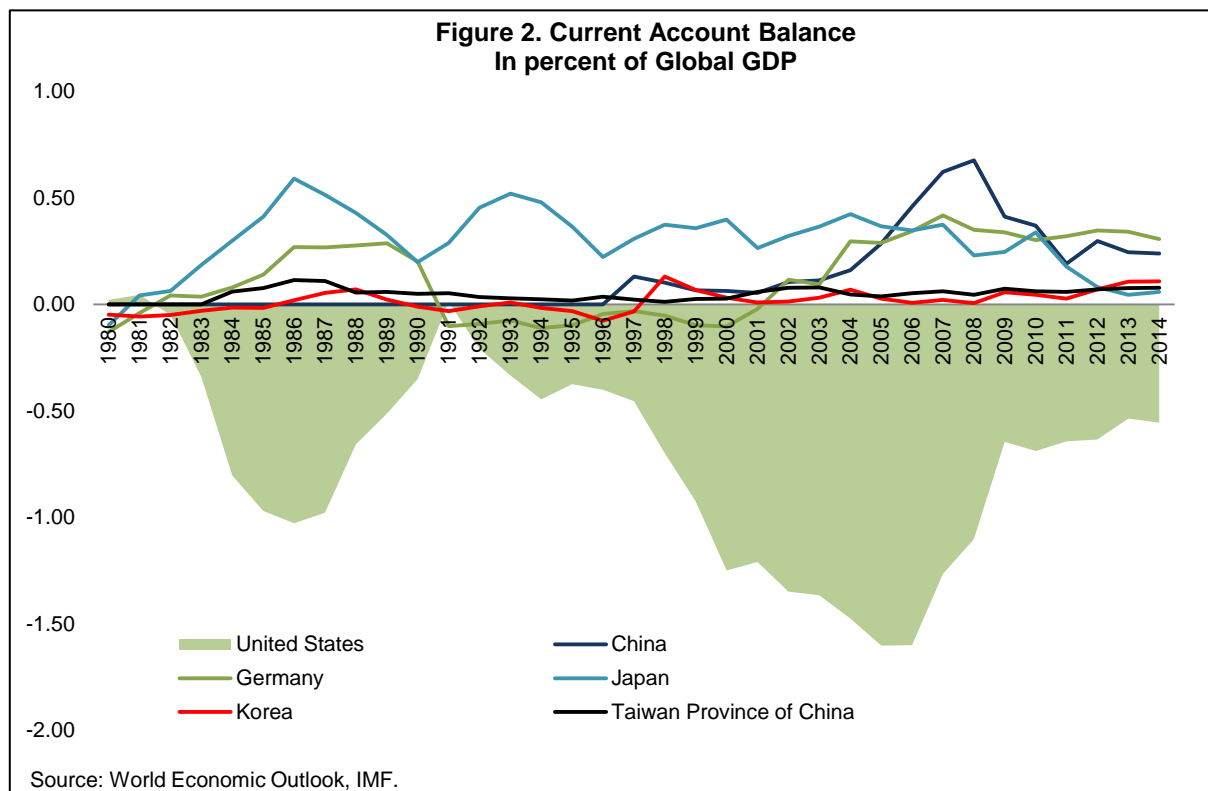
⁴ This includes Austria, Belgium, France, Germany, Luxemburg, Netherland, and Switzerland.

⁵ This group includes Belarus, Bulgaria, Czech Republic, Hungary, Poland, Moldova, Romania, Russia, Slovakia, and Ukraine.

Based on the population profile alone, most countries that served as the engine of growth over the last few decades should be net borrowers of savings in the period ahead with the to-date followers becoming the net providers. If they do not deliver, then the world will face acute shortage of savings in the period ahead, both in relative and absolute terms.

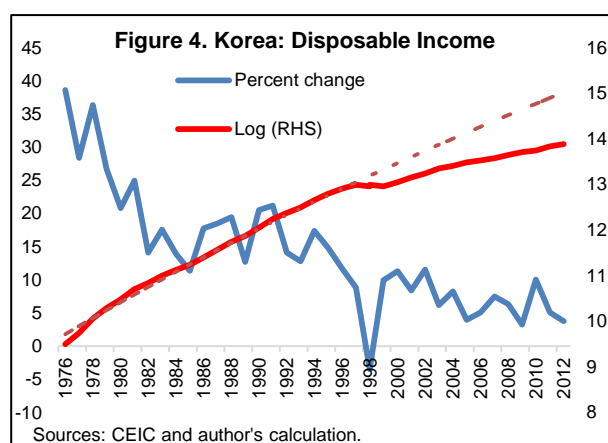
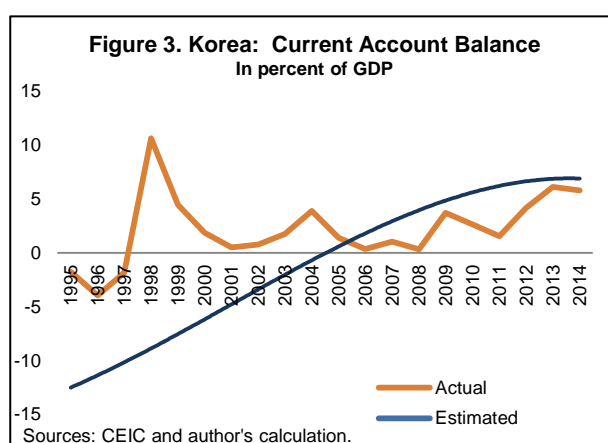
When compared with the actual data, the current account balances of China, Germany, Japan, and Korea (Figure 2) appear to have been broadly consistent with what population profile would have dictated. The United States, on the other hand, should have been a net lender instead of a borrower.

One other question that arises from the deviation of the actual from the PCCA is who should provide the needed global demand given the United States has already spent much more than is consistent with its population dynamics over the past two decades. Germany appears to have some room to move to a current account deficit, but to what extent the positive spillover will reach beyond the euro zone is unclear.



Korea's Current Account Balance

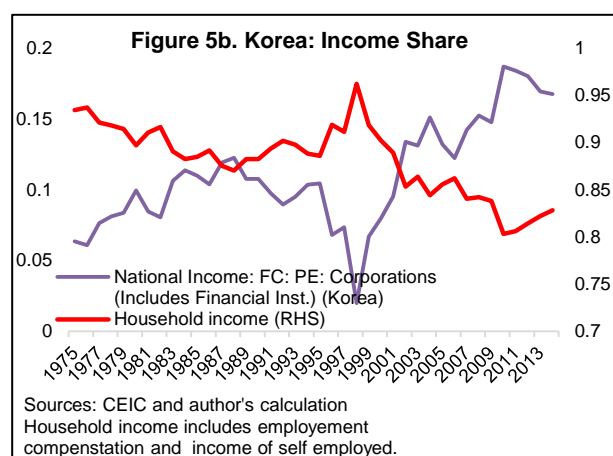
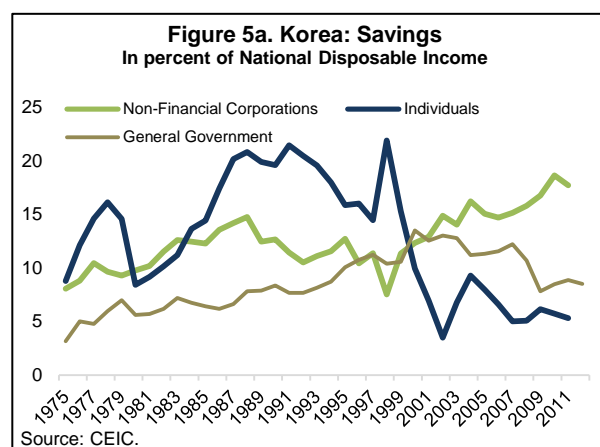
The external current account balance in Korea turned positive following the foreign exchange crisis in the late 1990s and has remained so since then. The initial surge in the late 1990s could be attributed to an overreaction to the shock. The widening of the surplus in recent years appears to be consistent with the PCCA (shown as “estimated” line in Figure 3) reflecting a rational decision to save for the aging population. This widening, unfortunately, also reflects a number of internal structural problems that raises concern about the sustainability of Korea's economic growth.



First, the increase in the current account surplus reflects not so much a decline in household consumption, but rather a decline in

household disposable income. As is clearly shown in Figure 4, the disposable income never fully recovered from the foreign exchange crisis in the late 1990s. Its level remained stagnant for a couple of years and then entered into a lower growth path.

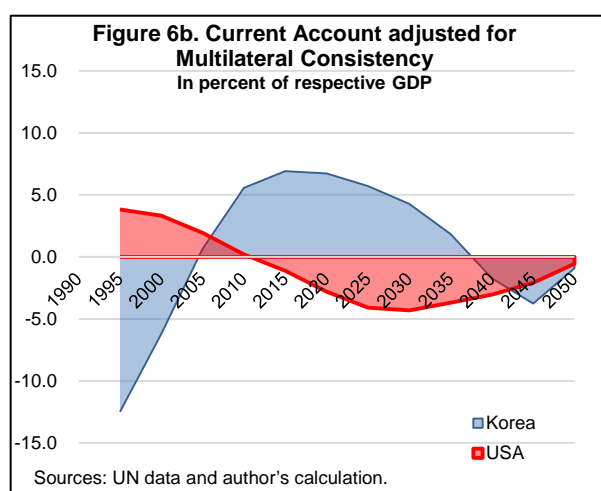
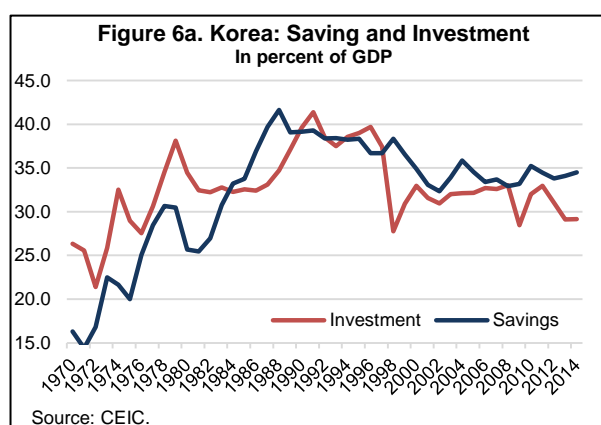
This sharp decline (Figure 5) also implies that households had less income to save as adjustment in spending pattern takes a long time. Accordingly, household savings fell by about 10 percentage points to 5 percent following the foreign exchange crisis. Overall savings, however, did not decline as much since corporate savings partly offset this decline in tandem with their increased earnings.



The recent widening of the current account balance is attributed to the decline in investment (Figure 6). The temporary blip in 2010-11 reflects large undertakings that are not part

of the gross fixed capital formation, e.g., land sales and purchases, reclamation work, possibly capturing river bank construction activities. Thus, the declining trend has already been in place for much longer than the headline numbers suggest.

Going forward, Korea faces a daunting challenge of promoting investment in order to lift growth at a time when demand prospects appear to be weak at best. Not only is consumption sluggish due to falling disposable income, but it needs to beef up savings now for future consumption. The increase in corporate savings will likely begin to fall eventually given the weak household consumption prospects. Exporting itself out of this impasse is not even an option since the rest of the world is facing a similar challenge of recovery.



For Korea, the most urgent policy objective is to focus on measures that would foster an increase in households' disposable income. This will reduce savings rate and also incentivize corporations to invest more. A sustainable increase is possible only when employment is expanded that is tied to creating new value added. This in turn requires moving closer to perfect competition, opening restricted areas for investment, and allowing new ideas to be fairly priced to encourage startups in nontraditional areas. The three year economic program announced last year and which has also been submitted as Korea's growth strategy to the G20 at the Brisbane Summit contain the right measures. In particular, they include policies aimed at strengthening anti-trust rules, enforcing market discipline including for intellectual property right, deregulating the services sector and reforming the financial sector to facilitate easier lending for credible businesses without collaterals. The challenge is in sequencing and implementation.

Macroeconomic policies may yield only a limited impact, or could even induce unintended results. For example, a revaluation of the won will reduce current account surplus. However, it will require a very large revaluation. Various quantitative assessments⁶ show the exchange rate to have played only a very minor role in recent widening of the current account surplus. Moreover, to the extent that demand for domestic products will decline due to the substitution effect, the initial positive income effect may be succumbed by this fall in domestically produced goods, which will reduce households' disposable income even further. Compounded by a decline in exports from the revaluation, the economy could fall into recession.

⁶ KIEP internal mimeo, March 2015. Panel data are used to assess contribution to Korea's current account balance. Main contributors of recent current account surplus in Korea are identified as terms of trade, domestic demand, and global trade.

Expansionary monetary policy and fiscal policy will have short-lived impact at best. Quantitative studies show that short term interest rates in Korea have little impact on domestic demand. It will raise consumption temporarily through debt, but is not sustainable as corporations will not raise investment as leveraged spending is not sustainable. Medium term interest rates, on the other hand, are heavily influenced by US yield curve, much more so than domestic short term policy rates. Expansionary fiscal policy will have to be large in scale to have any meaningful impact and also temporary given the aging profile of Korea's demography. Even then, it is not clear whether such spending will be able to raise household income on a permanent basis unless the underlying structural policies are addressed at the same time.

Closing Remarks

Global imbalance often comes into the fore in international policy debates as correction is thought to contribute to strengthening global demand. Proactive macroeconomic policies such as expansionary fiscal policy or revaluation (or allowing greater flexibility) of the exchange rate are particularly noted as solutions. Yet, market fundamentals such as aging indicate that current account imbalances should not necessarily decline, but rather, they should be redistributed across different countries according to fundamentals. In fact, only a few countries' actual current account surplus approximates their respective PCCA, and even fewer countries' correction of the imbalance could support global demand.

Closer review of Korea reveals that the case is much more complicated than policy debates often make it to be. According to the population profile, its current account surplus appears

to be broadly consistent with its population profile. However, the composition of its savings should shift from corporate to households; at the same time, there is scope for the corporate sector to increase investment. Moreover, a revaluation of the exchange rate could reduce current account balance, but it would require a large jump, which would not only be inconsistent with fundamentals but also possibly thwart the economy into recession.

To summarize, international debates should focus more on the need to fill demand deficiency through addressing the underlying structural impediments and corresponding macroeconomic policies to support attaining an equilibrium that is consistent with fundamentals. These structural reforms are urgent since the global economy continues to slip into recession. The United States, which based on its population profile alone could have been in a position to expand demand. However, it has already spent much more in the past than was consistent with its population profile. Moreover, as its spending was leveraged, it is likely that it spent more than its capacity to repay based on some measure.⁷ Thus, the rest of the world should now start taking on more responsibility in sharing the burden of providing the growth impetus as the US is trying to normalize its own economy. This burden sharing, however, should not be done through creating more leverage nor as a zero sum game. **KIEP**

⁷ See L Han, I Lee (2012), "Optimal liquidity and Economic Stability," IMF Working Paper WP/12/135 where they compare total financial assets held by nonfinancial institutions with the net present value of income generated from existing capital and technology.