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Current account balance and dollar standard: Exploring the linkages☆

Andreas Steiner

University of Osnabrueck, Institute of Empirical Economic Research, Rolandstrasse 8, D-49069 Osnabrueck, Germany

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A B S T R A C T

This paper examines whether the international role of the dollar as main global reserve currency has contributed to persistent current account imbalances. To this end, we analyse how central banks' accumulation of reserve assets affects the current account balance of both reserve-accumulating and reserve-providing countries. Based on a simple portfolio balance model we show theoretically that the global demand for reserve assets by central banks may lower the current account balance of the reserve-issuing country. Our panel data analysis over the period 1970–2009 confirms this hypothesis: Any dollar of provided reserve assets decreases the US current account by more than one dollar. On average, the demand for dollar reserves has lowered the US current account by 1–2 percentage points relative to GDP. The flip side of this effect is a higher current account balance in reserve-accumulating countries. These novel findings show that the worldwide demand for international reserves has contributed to the buildup of global imbalances.

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E-mail address: asteiner@uni-osnabrueck.de.

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1. Introduction

The global financial crisis of 2008–10 has revived the discussion about the causes and consequences of global imbalances and the net capital flows they involve. Global imbalances are considered to be among the causing factors of the global financial crisis (see Aizenman, 2010; Belke and Gros, 2010; Ferguson and Schularick, 2011; IMF, 2009; Obstfeld and Rogoff, 2010; Portes, 2009). They facilitated macroeconomic developments that led to the US housing boom and the accumulation of debt in the US.

A central question in international macroeconomics is how these imbalances can be explained.[1] While the literature traditionally centres on the question whether imbalances are caused by low US saving rates or an East Asian savings glut, this paper provides empirical evidence for a new interpretation: Central banks' demand for reserves sustains global imbalances. First, reserve-accumulating countries run larger current account balances. Second, the US current account deficit can partly be explained by its reserve currency status.[2] This is a crucial finding since according to the savings glut and low US savings hypotheses the US external imbalance is a temporary phenomenon, whereas we show that it is rather a structural outcome of the international monetary system. From this vantage point, the reserve currency status of the US is one of the macroeconomic factors that contributed to the unfolding of the global financial crisis.

Two stylized facts, which are illustrated in Fig. 1, motivate this paper:

1) During the past 30 years the US has been characterised by a persistent current account deficit, which has negatively affected its net foreign assets position[3]: In 1970 the US was a creditor country with net foreign assets amounting to 4.1% of US output. Current account deficits turned this net foreign investment position into deficit. In 2010 the US owes the rest of the world 17% of its output.[4]
2) Over the same period, central banks in the rest of the world have accumulated an enormous amount of foreign exchange reserves, which are predominantly invested in US assets. Since 1970 they have accumulated dollar reserves equal to 60% of US GDP in 2010.

To some extent the constellation with a current account deficit in the reserve-providing country is the natural outcome of the architecture of the international monetary system. Countries at the periphery have to export capital to the reserve currency country in order to buy the insurance provided by foreign exchange reserves. Their accumulation of dollar reserves constitutes an inflow of capital to the US and sustains net capital flows to capital-rich countries – the Lucas paradox.

By examining whether the international role of the dollar has contributed to the US current account deficit and its deteriorating net foreign asset position, this paper offers an empirical evaluation of the mechanics surrounding the Triffin dilemma. Triffin (1960, p.9) notes that "the additions to international liquidity [...] are entirely dependent on the willingness of the key currency countries to allow their own net reserve position to deteriorate, by letting their short term liabilities to foreigners grow persistently and indefinitely at a faster pace than their own gold assets". Kindleberger (1969, p.8) refers to Triffin stating that "reserves can be added only by new gold production, which is inadequate in some sense [...], and through deficits of the reserve-currency countries".

As a corollary of the insight that the provision of reserves might cause a deficit in the balance of payments, Triffin (1960) argues that any international monetary system that uses a national currency

[1] For a review of the evolution of imbalances and the dominant players refer to Belke and Schnabl (2013).

[2] In our terminology a country enjoys reserve currency status if its assets are held by foreign central banks as part of their international reserves. As such it is a narrow concept of the international role of a currency, which focuses on its importance for official uses as opposed to private uses. The terms "key currency status" or "financial centre" are defined by the role of currencies in private transactions. A financial centre provides intermediation services to the rest of the world and is characterised by large stocks of foreign assets and liabilities relative to GDP. Key currency status refers to the international role of a currency manifested by its use by private agents for the invoicing of trade or as a reference currency on the foreign exchange market.

[3] While it is true that the dollar served as major reserve currency long before the US current account turned into deficit, we argue that the current account surplus would have been larger without reserve status.

[4] Data are based on Lane and Milesi-Ferretti, 2007 and update, and WDI, 2011.

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