The Global Economy

Managing the New Global Imbalances 2009

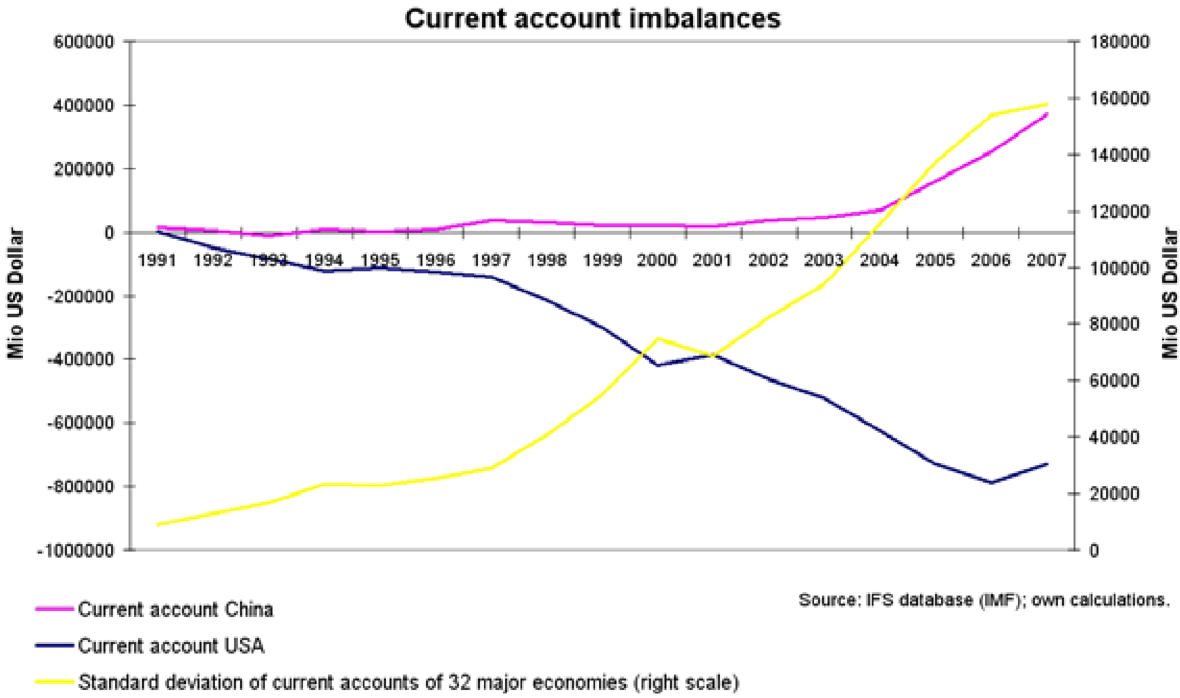
<u>The Challenges</u>

The financial crisis and the resulting global downturn have unwound some of the old global imbalances. For example, US household consumption as a proportion of income has fallen; Chinese government spending relative to GDP has increased. Nevertheless, the economic turmoil may give rise to new patterns of global imbalances.

Governments' ability and need to provide bank bailouts and fiscal stimulus have often depended on the size of their financial industry and the size of the national debt, rather than on the magnitude of previous global imbalances that required to be corrected. The severity of national recessions, along with the associated changes in trade flows and capital movements have depended in part on countries' different degrees of export dependence, energy production capacities and their past financial regulations.

These differences may generate new imbalances between countries with relatively large and relatively small financial sectors, raw-material-producing and raw-material-consuming countries, and relatively open and closed economies.

In the absence of proactive policy responses, what are the new global imbalances likely to be? How should monetary, fiscal, trade, structural and welfare policies of countries around the world respond to the prospect of new imbalances? What exchange rate regimes would be useful to prevent the new imbalances from arising?



Proposed Solutions

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During the ongoing financial crisis global imbalances as the current account deficit of the United States already has been reduced to some extent. Nevertheless, there are good reasons to believe that when the financial crisis has passed the new global imbalances will be first of all the old ones. In East-Asian countries like China underdeveloped financial markets and precautionary saving will play further an important role in the medium term and may reinforce the "saving glut." Oil exporting countries are likely to be net savers in the future as well. In contrary, countries that have run large current account deficits so far, excessive consumption may switch from the private to the governmental sector for several years.

At this point it may worthwhile to stress that global imbalances are not bad in general. Indeed they are reflection of capital flows among regions and help to employ capital where it is most productive. Thus, future policy measures should not seek to prevent imbalances per se. However, imbalances that reflect unsustainable economic developments should be prevented in future by appropriate institutional frameworks.

First of all structural policies in countries that have run excessive surpluses or deficits can help to hold global imbalances at a sustainable level. An improvement of financial markets and the social security system in East-Asian countries will decrease private savings in this region. Obviously such structural changes take time and will not be a short-run solution. In those countries that have run large deficits due to overconsumption as a result of a housing boom country-specific regulation of the financial market may help to prevent the reoccurrence of such bubbles.

In this regard global regulation of financial markets and financial markets participants may play an important role, too. Apparently financial institutions took on too much risk. There is some reason to believe that the same underlying faults that led to financial crises also supported global imbalances to rise. One example may be the excessive mortgage supply for non-creditworthy homebuyers in the United States that were financed via structured securities internationally. Therefore an institutional framework that stabilizes financial markets at a global level could be one cornerstone in preventing unsustainable global imbalances in the future.

Frequently it is argued that the exchange rates play an important role for the emergence of global imbalances. The systematic intervention on the exchange rate market of some Asian countries to avoid appreciation of their currencies and strengthen exports – from time to time called Bretton Woods II – was the main driver of the past imbalances and may trigger imbalances also in the future. If so, then policy should concentrate to receive binding commitments from all countries to allow exchange rates in future to float more freely and to do not intervene at those markets. However, many studies point toward a minor role of exchange rates in determining the trade balance of a country. Furthermore there may be good reasons for countries to stabilize their exchange rate that do not aim exclusively on the trade sector. One example may be to increase the attractiveness for foreign investors.

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A simpler way to solve the "dollar problem" and avoid a new inflationary cycle

When China's Premier Wen Jiabao recently expressed concerns about the future of the US dollar, the currency in which most of his country's official reserves are denominated, his remarks provoked contrasting reactions among US economists.

Some, like Fred Bergsten of the Institute of International Economics, exhorted the US government to take Mr. Wen's concerns seriously and listen to Beijing's suggestion to create a substitution account in the IMF, which would allow Fund members to exchange unwanted US dollar balances for SDRs, as part of a gradual process to replace the dollar with a supranational reserve currency over the long run (Mr. Bergsten was particularly enthusiastic about the substitution account idea since it matched a similar proposal he had made in 2007, see Fred Bergsten, "We should listen to Beijing's currency idea," FT April 8, 2009, and "How to solve the problem of the dollar," FT December 11, 2007).

Other US economists, including last year's Nobel laureate Paul Krugman, were less enthusiastic. According to Mr. Krugman (Paul Krugman, "China's dollar trap," New York Times, April 2, 2009), China had fallen into a trap of its own making due to its reluctance to adopt a more flexible exchange rate policy in the past. Since any attempt by China or any other country to diversify away from the US dollar too much or too quickly would be self defeating, there was no immediate threat to US or world financial stability, hence no need for the US government or the IMF to intervene on China's behalf.

In our opinion, Mr. Krugman's view is very simplistic for it fails to take into consideration the effect that a large amount of unwanted dollars and dollar assets will have on inflation once recession fears dissipate. It is possible that Mr. Krugman believes that some increase in inflation is a good thing, as it could help cure the "dollar overhang." If so, he is not alone. Kenneth Rogoff, the former chief economist of the IMF, has recently written that "a sudden burst of inflation would be extremely helpful in unwinding today's epic debt morass" (Kenneth Rogoff, "Embracing inflation," The Guardian, UK, December 2, 2008). Put in other words, by increasing inflation, the US would "solve" two problems at once. On the one hand, it would debase the value of its national debt, hence preventing it from growing too much relative to GDP. On the other, it would reduce the real value of the debt (unsecured and secured) of financial institutions and other US corporations, hence diminishing the need for explicit haircuts or public bailouts.

The problem with this "solution," aside from the reputational problems it creates for the US government, is that once the inflation genie is out of the bottle, it will be very difficult to put it back in. As for the solution proposed by the Chinese central bank and Mr. Bergsten, there are, unfortunately, several problems. First, the plan requires a complex multilateral negotiation, including a change in the IMF's Articles of Agreements, which is unlikely to be supported by the US, if anything because the SDR will compete with the dollar as a reserve currency unit. Second, the proposal restricts the menu of potential dollar substitutes to the SDR, itself a basket of currencies with a predominant dollar share. Third, a substitution account in the IMF makes the IMF rather than the US government liable for losses resulting from the depreciation of the dollar vis-à-vis the SDR, a condition likely to be opposed by other Fund members.

However, the most important drawback of the China/Bergsten proposal is that it does not really protect US official creditors from a persistent fall in the dollar. This is because in the event of a protracted dollar depreciation, it is highly unlikely that the central banks of Europe, Japan, and the UK will stay put and let their currencies appreciate. More likely, these countries will resist appreciation by engaging in a process of competitive devaluations, the end result of which will be an increase in global inflation. If so, the reserves of China and other emerging markets will lose real value whether they are in dollars or SDRs. More importantly, inflation will be high everywhere in the world, and it will take years of high real interest rates and low growth to bring it down.

Fortunately, there is an easier and better way to protect the value of emerging market reserves while reducing the risk of a resurgence in world inflation. This is to reduce the incentive of the US government to “inflate its way out of debt.” For this to happen, all US creditors need to do is demand that the US government swap nominal US Treasury bills, notes, and bonds for inflation-adjusted instruments (TIPS) on demand. Since, at present, the supply of TIPS is very small in relation to the rest of the US national debt, bilateral coordination would be necessary to avoid distorting their value.

One of the advantages of this idea is its simplicity. For starters, it can be executed bilaterally rather than multilaterally. This not only makes it easy to implement, but also gives the US government leverage to extract concessions from the other governments. For example, in the case of China, it would be possible for the US to negotiate a quid-pro-quo, whereby China commits to reforms geared to reducing its structural current account surplus – including, but not limited to, a more flexible exchange rate policy. For this reason, it would be preferable that the swap proposal comes from the US rather than from its creditors.

But, more important than the practical advantages are the beneficial long term effects of such a policy, particularly in averting the specter of global inflation. By substituting TIPS for nominal bonds, the US government would be sending a strong signal that it does not plan to “inflate its way out of debt,” as disingenuously suggested by Mr. Rogoff but, to the contrary, will commit itself to adopting a more disciplined monetary and fiscal policy going forward.

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Back to the future: Reinventing financial stability role of central banking

Global imbalances have played a dominant role in the manifestation of the ongoing financial crisis. High savings rate and low investment spending have led to large current account surpluses in emerging market economies (especially in South East Asia). This surplus was matched with large current account deficits in developed economies (in the US in particular) resulting in capital flows from the former to the latter. In theory, the adjustment of these imbalances would take place through either exchange rates or interest rates or both. However, this was not happened for at least two reasons.

First, emerging economies built up huge foreign exchange reserves to fight against appreciation of their currencies. This was, in part, a response to 1997 Asia crisis, when sudden capital outflows caused massive depreciation in currencies of many Asian countries. These reserves were recycled back to the US, which kept US dollar strong and interest rates low, leading to further decline in savings rate and fueling the consumption boom.

Second, a fear of deflation following the 2001 recession led policymakers to keep short-term real interest rates low for an extended period. Since many fixed or quasi-fixed exchange regimes used the US dollar as a reference currency, they imported the monetary policy of the Federal Reserve as well. The marginal productivity of capital was higher in emerging market economies. Therefore, the price of capital should also have been higher. Search for higher yields also changed the risk taking behavior of the financial institutions and led to acceleration of financial innovation. The natural consequence of accommodative monetary policies in major economies (both developed and emerging) was unprecedented economic growth worldwide coupled with double-digit annual growth in asset and commodity prices.

There is a fierce dispute about who is responsible for the current crisis? Fed critics blame the accommodative monetary policies that kept policy rates too low for too long. Others argue that it is the excessive reserve accumulation of China and other Asian countries that prevented the functioning of the international monetary system. The Triffin Dilemma is once again at the center of this debate. In 1960 Robert Triffin, an American economist, stated that the use of a national currency as global reserve currency leads to a tension between national monetary policy and global monetary policy. In retrospect, the policy rates in the US in early 2000 might be too low for the global economy, but the mandate of the Federal Reserve was to reach price stability and full employment in the US, not all around the world.

We should also question the mandate of central banks, which is typically restricted to sustaining stability in the prices of goods and services. It was not always so. In fact, if we go back to the early days of central banking in England, the United States and the continental Europe, we would notice that central banks were founded by political authorities or local businessmen to act as a lender of last resort to the banking sector during times of financial crisis, not to maintain price stability. Other responsibilities were of secondary importance. During 1970s, in response to high and persistent inflation, central banks gained the reputation of inflation fighters, which reached its peak when Paul Volcker became the chairman of the Federal Reserve. In 1990s, the popularity of inflation targeting has drawn more attention to price stability objective, overshadowing the original obligation of all central banks: financial stability.

Today, many people debate the need for a new global reserve currency, creation of an international clearing system, and establishment of a supra-national body to safeguard global economic and financial system. These discussions are necessary and maybe overdue.

A global reserve currency might be needed to solve the Triffin Dilemma. Creating an international clearing agency between trade partner countries may be useful to reduce the need for accumulating foreign exchange reserves. A supra-national body may be the only solution for the externality problem in the Bretton Woods system and its successor, so called, the Bretton Woods II: i.e., the economic and regulatory policies adopted by reserve currency issuers do not match the needs of the global financial system. Countries are affected by decisions over which they have no control, and policy makers take decisions ignoring their effect on other countries. In fact one reason for the devastating effect of the crisis and the speed of its propagation was that it originated in the reserve currency issuer. A supra-national body may overcome this externality problem.

However, all these efforts, even if they reach a satisfactory conclusion, may still be incomplete, if the main responsibilities of central banks are not redefined. Maintaining price stability should remain the primary objective, but that must comprise of asset prices as well. It may be challenging to determine what asset prices to target or how to identify bubbles in asset prices. Part of the challenge comes from the fact that central bankers have overlooked the excesses in asset prices for a long time. Maintaining that ignorance, however, may be too dear, as witnessed by the current crisis. It may also be challenging to convince the public about the necessity of raising policy rates at a time when economy is booming but the prices of goods and services are stable. Again, the recent crisis has demonstrated that central banks may ignore imbalances in financial markets at their own peril. It is time for central banks to go back to their roots.

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The global crisis: The role of policies and the international monetary system

1. Global imbalances and the financial crisis: A macro view

Both, the trigger of the global financial turmoil that started in the summer of 2007 and its proximate causes were essentially financial in nature, and originated in a specific segment of US financial markets. Distorted incentives, inadequate risk management and lax supervision encouraged the financial sector to take increasingly large, poorly understood risk exposures, financed through high leverage and a growing reliance on wholesale short-term funding. However, it is unlikely that all this would have developed to the same extent had the macroeconomic environment not been characterised for a long time by low interest rates, rising asset prices and large saving-investment imbalances in the United States and, with opposite sign, in Asia and the oil producing countries. All this was reflected in growing worldwide external imbalances and created enormous stress for a US and global financial system in which financial innovation and regulatory failures had progressively introduced serious structural flaws. Moreover, the complacency on the part of risk managers and financial supervisors that allowed the resulting vulnerabilities to grow unchecked owed much to the climate of general optimism that those macro conditions supported.

The lack of sufficiently decisive policy reactions to the external imbalances that began to expand rapidly from the second half of the 1990s was crucial. Essentially these disequilibria reflected rapid and sustained growth in final demand, especially consumption demand, in the leading economic region of the planet, financed by over-borrowing, primarily from abroad. Growth, in short, has occurred without household savings in the United States and with excess savings in other major economies. If the United States has served as a sort of "consumer of last resort," other large advanced and emerging economies have implicitly or explicitly followed an export-led growth strategy, which is difficult to maintain indefinitely but also difficult to abandon.

So far, the global recession has not righted the fundamental macroeconomic imbalances that lay at the root of the crisis. At present, the rise in US private sector saving and the sharp fall in investment, partly offset by a larger public sector deficit, appear to have narrowed the US current account deficit. However, much of the reduction is due to cyclical factors. The counterpart of a smaller US deficit has been a reduced surplus of oil exporting countries, while China's surplus has further increased, but at a reduced pace. Furthermore, the US international investment position deteriorated significantly in 2008, as the valuation effects – which until 2007 had largely offset the cumulated current account deficits – turned unfavourable as a result of the US dollar's appreciation and the large fall in equity prices. As the world economy comes out of the crisis, we face two alternatives: if US domestic demand growth is sluggish (as households repair their financial position), and if this is not offset by a more dynamic demand growth in other major economies (Europe, Japan, China), the world economy as a whole will face a slow recovery; on the other hand, if the recovery were once again driven by US demand, imbalances will widen again, and the risk of a "sudden stop" in their financing will reappear.

For a while, since the beginning of the financial turmoil, exchange rates have not generally been moving in a direction that favours the correction of imbalances. The US dollar has appreciated as the turmoil engendered demand for dollar liquidity and large capital flows out of emerging markets sought a safe haven in US Treasury securities. Those flows were partly reversed in the most recent months as investors' flight to safety abated and the financial situation started to normalise. Given the considerable uncertainty that exists on what will be the speed and the driving forces of the economic recovery in the main economic regions, it is difficult to predict, at this stage, whether the dollar will resume the trend of gradual de-

preciation that prevailed from 2002 to mid-2008. An added element of uncertainty is connected to the large increase in US public debt, a large share of which is held abroad. Market concerns about its sustainability could potentially also trigger disorderly exchange rate movements.

This could pose a difficult challenge to countries that have accumulated large quantities of US dollar reserves. However, continuing to peg their currencies might only postpone the day of reckoning, while increasing the potential capital losses. This dilemma is exacerbated by the fact that no country can act in isolation, as the present and potential effects on trade flows obviously need to be taken into consideration. Indeed, this is a classic case in which collective action, if feasible, would be welfare-improving. It might take the form of a cooperative agreement among surplus countries for some kind of joint "managed currency appreciation" vis-à-vis the US dollar. The appreciation and the boost to domestic demand would have to be large enough to ensure a significant correction of imbalances.

But is such collective action feasible? Several practical problems would need to be overcome. Even confining the discussion to Asia, the countries that would have to take part in it differ in many ways: current exchange rate regimes (hard peg, crawling peg, managed floating); degree of capital account liberalisation; stage of financial development; trade specialisation and position in the vertically integrated Asian manufacturing industry. These differences make the determination of how best to achieve the desired result extremely tricky: how large should the appreciation be, and should it be uniform across surplus countries? Is it better to implement it gradually or through one large initial exchange rate realignment? And after that, should exchange rates be managed or allowed to float, to let the market determine the final size of the adjustment? These are difficult questions, to which there are no obvious answers.

2. The role of policies

In order to reduce the risk that again in the future a combination of macroeconomic imbalances and distortions in the financial system may lead to large and destructive financial crises, it is essential to address the policy failures that made the current crisis possible. Important changes in the regulation of financial markets and banking institutions are already being introduced. However, macroeconomic policies also bear their part of responsibility. Two areas where a rethinking is needed are most likely monetary policy frameworks and the international monetary system.

It has been argued, convincingly, that as a result of the success achieved by macro-stabilisation policies and of structural changes in the responsiveness of aggregate supply (also as a result of globalisation), inflation expectations are now much better anchored, and episodes of excess creation of liquidity and credit tend to be reflected primarily in asset price bubbles, rather than in increased consumer price inflation. However, the task of monetary policy in this context is not necessarily easier. Because asset price cycles tend to be associated with large changes in indebtedness and add to financial vulnerabilities, they can pose significant risks to financial stability. This brings us to the time-honoured question of whether and how monetary policy should react to asset price misalignments and financial imbalances, or more generally whether central banks must (flexibly) target, with just a single policy instrument, more than just consumer price inflation.

It has been suggested that, to take into account the effects of asset price movements in the context of a flexible inflation-targeting framework, central banks may need to look further into the future than it is usual. This might work in "normal" times. However, since the precision of forecasts can only decline as we move to more distant time horizons, it is debatable whether trade-offs that depend on forecasts of the distant future and are by their very nature rather uncertain can be stable enough to provide reliable guidance for current policy decisions. Furthermore, one may ask whether this may be too general a framework to provide actual guidance to monetary policy. If allowed to develop, asset price bubbles and the financial instability that usually accompanies them can eventually destabilise expectations about future monetary policy and inflation, especially if the practice is followed by always intervening to "clean up" after the bubble has burst, easing policy by as much as it is required to offset the effects on the economy. The difficult question of how much restriction would be needed in the face of rising asset prices calls for more study and experimentation, including, of course, that of recurring to other instruments within what is now called "macro-prudential" policy. But, as it has been aptly suggested, it hardly calls for "benign neglect."

A key element that allowed the US monetary expansion and China's exchange rate pegging to be maintained for so long was the fact that they were mutually reinforcing. In a nutshell, demand from US consumers helped sustain China's (and others countries') export growth. At the same time, an elastic supply of cheap imports from Asia helped keep inflation low in the United States (and also, by the way, in the other advanced countries), encouraging the Fed to maintain an easy monetary stance. And the investment of emerging economies' official reserves in US Treasuries contributed to compress long-term yields both in the United States and globally. All this fed global liquidity and rising asset prices.

The countries that pegged their currencies to the US dollar effectively imported US monetary policy regardless of whether it was appropriate for domestic conditions. This fuelled liquidity and credit expansion, also because of difficulties in sterilizing the effects of the accumulation of official reserves, and tended to feed booms in domestic asset prices and investment. But the high growth experienced by these countries effectively rested on the ultimate support coming from US consumers. This became evident most recently: when it was clear that the financial crisis might involve a massive credit crunch and would require a protracted re-balancing on the part of US households, the fall in demand and world trade was highly synchronised in all advanced and emerging economies. Other surplus countries also had a responsibility in allowing the imbalances to grow. In Japan, long delays in facing up to the structural problems of the financial sector caused a prolonged stagnation of demand. Also European countries introduced some structural reforms to the labour market in recent years, but these, in the absence of equally forceful reforms in product markets, have largely translated into stagnating wages and weak domestic demand.

The fact that imbalances that were not sustainable persisted for so long shows that no mechanism – market-based or activated by multilateral surveillance – operated effectively to induce a correction. Two closely connected features of the international monetary system seem to have effectively switched off market-based alarm bells: first, by pegging their currencies to the US dollar, surplus countries managed to avoid pressure to adjust; second, the role of the US dollar as the international reserve currency implied that the United States could finance persistent current account deficits without coming under market pressure, as long as the surplus countries were willing to accumulate dollar assets. For the United States, an added benefit of financing deficits in its own currency was that dollar depreciations generated favourable valuation gains on its international investment position.

Underlying all this is the fact that the international monetary system that emerged after the demise of Bretton Woods is a non-system, driven by the revealed exchange rate preferences of the individual countries, with a very weak multilateral surveillance, despite recent attempts to strengthen it. Although it is clear that the international monetary system has not been performing some of its essential functions, it is by no means clear what could replace it. If the key source of its shortcomings is the US dollar standard, it is difficult at this stage to identify a realistic alternative. All those that have been mentioned – a supranational currency like the SDR; a tripolar system based on the dollar, the euro and an Asian currency – face very substantial difficulties. Whatever the final goal, mechanisms to counter disorderly adjustments in exchange rates, as well as the establishment of an SDR-denominated substitution account for existing stocks of official reserves, as recently suggested, may be worth of further consideration as means to smooth the transition.

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Global imbalances have a long history. The US current account deficit has been persisting for the last five decades with its most visible counterpart shifting from Germany to Japan and now to China. This history leads us to a presumption that imbalances will not easily go away. One possible scenario could be for the US public sector to run a substantial budget deficit even as macro economy normalizes, thus replacing excessive household spending as the main source of domestic saving deficiency. The "twin deficits" will likely be financed partly by improved domestic savings but have to rely on capital inflow as well. Under this scenario, the US external deficit would be largely policy-driven and therefore contingent on successful exiting of macro economic policies inter alia fiscal policy.

A related question is how global imbalances manifests itself as a major source of risk. Historically it was mainly discussed as various forms of dollar crisis, involving substantial fall in the dollar's value leading to turbulence of international monetary system. However, in the last two years, we have seen deep crisis of international financial systems, but not a classic dollar crisis. In fact, the resilience of the US dollar has been notable given the near melt down of the US financial system as well as the deepest recession since the thirties. Interdependence through trade and financial linkages appears to have produced an environment in which the US dollar may play a role of safe haven currency even when the US happened to be an epicenter of crisis as has been the case. Accepting that, the US dollar could still be sold and depreciate in the event the US authorities failed to make a successful exiting, as such policy performance would be seen as inviting higher inflation pressure relative to other major currency areas (especially Euro area).

Thus, over the next few years, exiting strategy and performance of the US (and other key economies) seem to matter very much to how global imbalances and the US dollar may evolve. In the process, central bank independence and price stability objective should be firmly adhered to, as monetary policy may often be exposed to political pressure to accommodate large public sector borrowing needs.

Is it feasible to radically change macro economic balances of key surplus countries, i.e. enhance domestic demand (particularly consumption) and reduce net savings? The Japanese experience does not offer an encouraging example: policy efforts to strengthen domestic demand either failed or ended up with financial bubbles. It may well be a demographic change that is finally delivering much lower savings rate and moderate current account surplus. China also is endeavouring to enhance consumption rate with less than desirable results. China's development is also unique in that business sector has significantly increased net savings balance while investment has expanded at explosive rates. Without some substantial demand switching, triggered by exchange rate adjustment, it is difficult to envision China with much reduced surplus. The past and current experiences of Asian economies suggest that it is still uncertain how best to treat external balance within the context of a nation's macro economic management. In this situation, it is important not to politicize the imbalances as such moves can easily shift to protectionism.

Finally exchange rates still matter in moderating imbalances. Obviously countries cannot always agree on the appropriate levels of rates. But close consultation and sometimes concerted actions in the market has been conducted among the G7, and it has been helpful to maintain orderly market conditions. The same efforts are now being called for involving some key emerging market players. G20 appears too big to conduct effective dialogue on delicate matters. A new G5 (?) framework to talk informally about macro and market issues a la G7 is desirable.