Global Imbalances, Financial Crisis and Economic Recovery

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Global current account imbalances, expressed as percent of world GDP, have narrowed considerably since 2006. According to the IMF, however, the quality of this adjustment leaves much to be desired. Most of the adjustment took place during the global financial crisis of 2008-09, reflecting lower demand in economies with external deficit. Whereas exchange rate adjustment played some role, policy adjustment contributed "disappointingly little".[1] Hence the IMF prescribed a broadly unchanged set of policies to further reduce global imbalances: 1) the two major surplus countries, China and Germany, need more consumption and investment, respectively, 2) the major deficit economies, including the U.S., need to boost national savings through fiscal consolidation, 3) other deficit economies also need structural reforms to rebuild competitiveness. Conspicuously missing from this prescription was what was to be done with macro-financial linkages, which played a critical role in the build-up to global imbalances. Unless savings-investment perspectives on the balance of payments are complemented by financial-capital perspectives, policy prescriptions for resolving global imbalances may interfere with economic recovery and leave intact many of the factors that contributed to the global financial crisis.

Before the global financial crisis, global imbalances typically referred to the persistent, large current account deficit in the U.S. matched by persistent, large current account surpluses in the rest of the world, especially China. Politically, the problem of global imbalances was often framed as a bilateral issue between the U.S. and China, focused on the nominal exchange rate. Many economists believed at the time that 1) the global imbalances were not sustainable, 2) correction would be disruptive, and 3) the more the correction is delayed, the bigger the disruption would be. The dynamics leading to the crisis was conceptualized as follows: the build-up of current account deficits by the U.S. would shake investor confidence and lead to a sudden stop of capital inflows, which in turn would precipitate a large and swift fall of the U.S. dollar and a steep rise in the U.S. interest rate and risk premium. The resulting disruptions could lead to a deep recession.[2] To resolve global imbalances, it was recommended that countries with current account surplus increase consumption and countries with current account deficit increase national savings, with requisite structural reforms. Policy recommendations also included exchange rate adjustment to correct "fundamental misalignment".[3]

This diagnosis of global imbalances was problematic on multiple accounts. First, reducing current account imbalances to zero should not be a policy objective in and of itself. Even if the savings-investment gap is large, it can be sustained if the imbalance in the capital and financial account is equally large in the opposite direction. As long as capital flows are channeled into productive uses for which the return on investment covers the opportunity cost of capital on a sustainable basis, a large current account deficit by itself does not lead to a crisis. A capital-poor country with good growth prospects provides a prime example where a current account deficit actually represents a win-win situation for borrowers and lenders alike. By contrast, even if the imbalance in the current account is not large, a sudden change in capital flows may precipitate a crisis. For example, a country even with solid growth fundamentals can get into serious trouble if it does not have enough liquidity to deal with abrupt capital outflows. Hence an exclusive focus on achieving zero imbalances through policies that affect the savings-investment gap is misguided. Instead, policy prescriptions should also cover financial resource allocation and micro- and macro-prudential issues, as well as financial safety nets to deal with capital flow reversals.

Second, the pre-crisis discussion on global imbalances under-appreciated the privileged position of the U.S. dollar as the world's leading reserve currency and safe-haven currency in a time of crisis. The U.S. does not suffer from the "original sin"[4] as it issues debt denominated in a currency under its control. Because the U.S. can print dollars to pay off debt if necessary, a sudden stop of capital inflows would not trigger a currency crisis. Also, if the U.S. is concerned that the accumulation of its current account deficits would shake investor confidence and ultimately undermine the privileged position of the dollar, it has under its disposal policy tools to address the problem. Most simply, it could raise the interest rate, which would reduce the savings-investment gap by dampening domestic demand. It could also try to prevail on current account surplus countries to appreciate their currency or boost their economy. This would allow the U.S. to increase its net exports without having to raise the interest rate to dampen domestic demand across the board.

In the first half of the 2000s, however, the U.S. failed on both domestic and external fronts to deal with its rising current account deficits. In 2001, in the wake of the collapse of the IT boom, the Fed slashed the target federal funds rate from 6.50 percent to 1.75 percent. Over the next three years, due in part to high unemployment and low inflation, the Fed made additional interest rate cuts. But the resulting interest rate around 1 percent was well below the level consistent with the Taylor rule. In fact, although the Fed began raising the rate from June 2004, the policy rate in real terms remained negative until late 2005. Combined with imprudent financial deregulation, the low interest rate fueled a housing market boom, where escalating asset prices helped justify further investments. Although the return on investment appeared to cover the opportunity cost of capital for some time, housing prices became unsustainably high compared with the fundamentals, and borrowers' ability to pay back debt deteriorated over time. On the external front, the U.S. did not have as much negotiating leverage over China as it had over Japan in the 1980s to craft a second Plaza Accord. China built up its foreign exchange reserves well beyond the level justified by precautionary motives and strategically used these reserves for its foreign policy objectives. The purchase of U.S. government bonds by China and other countries with current account surplus also helped to keep long-term interest rates low, providing further support to the housing market in the U.S. The year 2006 marked the peak of the U.S. current account deficit, at six percent of GDP. Although domestic and external adjustments had begun to be made by then, they were too little, too late. To sum up, the popular doomsday scenario for global imbalances under-appreciated the privileged international position of the U.S. dollar on the one hand and the risk of domestic financial resource misallocation on the other. Global imbalances subsequently led to a financial crisis, not a currency crisis.

Third, the build-up of global imbalances before the crisis was much more than a bilateral issue between the U.S. and China. On the deficit side, the U.S. clearly dominated the scene as early as 1998. However, since the launch of the euro in 1999, the combined current account deficits of the eurozone periphery (Greece, Ireland, Portugal, Spain, and Italy) increased rapidly, from 3 percent of their combined GDP in 1999 to 8 percent in 2007. On the surplus side, although China and Emerging Market Asia received most of the attention in pre-crisis discussions on global imbalances, the current account surpluses of Germany, Japan, and oil exporting countries were significant as well. Driven by precautionary motives in the aftermath of the Asian economic crisis of 1997, Emerging Market Asia accumulated foreign exchange reserves to guard against sudden capital flow reversals. In the case of Germany, its current account balance swung from -1 percent of GDP (deficit) in 1999 to plus 7 percent (surplus) in 2007. Over the same period, Germany's international competitiveness (proxied by unit labor cost trends) improved a great deal. Had it not been for the currency union, the German mark would have appreciated to reduce its current account surplus. But the launch of the euro took away this option. Alternatively, if the corresponding capital inflows into the eurozone periphery had been invested productively on a sustainable basis, their current account deficits might not have become a problem. However, what happened instead in the eurozone periphery was a finance-driven boom and bust similar to the one in the U.S. In the case of Japan, it failed to deal resolutely with deflationary pressure and zombie lending, and instead opted for an odd combination of output being produced to satisfy external demand, while demand in the large domestic market stagnated.[5]

Even in the aftermath of the global financial crisis and the ensuing deleveraging shock, many of the pre-crisis ideas about global imbalances still had considerable influence on policymaking. Calling the eurozone crisis a "fiscal crisis" and prescribing austerity might be the most egregious example. Conveniently overlooked in this prescription is the macro-financial linkage. The eurozone periphery had benefited from lower capital costs since 1999, but massive capital inflows helped to fuel asset price escalation. And when the deleveraging shock occurred, they had to face sharply rising interest rates and depressed growth prospects. In some cases, they had to stabilize the financial system by injecting public funds to take over nonperforming loans and recapitalize the banking sector. The combination of these factors dramatically raised the public debt-GDP ratio. Fiscal consolidation would not solve this problem.

Fortunately, there has been important progress as well. Faced with a weak economic recovery and uncertainty about fiscal policy, the Fed aggressively pushed quantitative easing (QE). Although the Fed justified its action on the basis of its domestic mandate to promote "maximum employment, stable prices, and moderate long-term interest rates," not international bargaining, it demonstrated that the U.S. still has the power to create problems for others if they do not cooperate. In other words, the U.S. might not have the leverage to pull off a second Plaza Accord, but it has the power to affect the global economy if others are slow to make the necessary adjustments, as was the case in 2010. If the U.S. can avoid premature QE tapering and abrupt fiscal contraction, its recovery should gather steam as the private sector's balance sheet has improved. Faced with QE and the risk of dollar devaluation down the road, China understands that an aggressive build-up of foreign exchange reserves is unwise. In fact, China's current account surplus relative to GDP declined from the peak of 10.1 percent in 2007 to 2.3 percent in 2012. China's main concern now is minimizing the risk of financial resource misallocation by the shadow banking sector and avoiding the mistakes that the U.S. and Europe made before the global financial crisis. A slowdown in the rate of growth may be the price China pays for an improvement in the quality of growth. Japan, for its part, finally began to fight deflationary pressure with aggressive monetary and fiscal policy of its own. It remains to be seen, however, whether Japan will be as resolute in dealing with zombie lending and other structural problems. Even in the eurozone, policy discussions appear to be turning away from fiscal austerity. Due to tepid economic recovery and slow progress in deleveraging and restructuring, however, the eurozone faces tougher challenges than the other economies.

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Endnotes

[1] See IMF (2013): 12.
[2] See Edwards (2005).
[3] See Blustein (2012).
[4] See Eichengreen, Hausmann, and Panizza (2003).
[5] See Hoshi and Kashyap (2011).