26 Persistent global imbalances

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This chapter argues that, in one way or another, the world will have to reach agreement on a mechanism to avoid these imbalances. Whether that happens because of lessons learned in the current crisis, or whether it takes another crisis before the policy community is motivated to action, is still a question.

Despite the global recession and the near-miss of a catastrophic financial meltdown, policy actions so far have not addressed a major underlying factor that made the situation so bad: global imbalances. While many phenomena intensified the crisis, at its root was the very low real interest rate that the global economy sustained in the 2003-2007 period. That low (and sometimes negative) real interest rate had several repercussions: it made borrowing to finance construction more attractive, increased the demand for housing (and for upgraded quality of housing) much more than would have happened at higher real interest rates, made borrowing costs low for governments, reduced incentives to save in countries with current account deficits, and led financial institutions to a search for yield far beyond what would have taken place at a higher interest rate. While there would have been housing booms, development of new financial products, and other factors which have been blamed for the crisis in any event, their magnitude, and hence the costs of the downturn, was greatly amplified because of low real interest rates.

Causes of global imbalances

Global imbalances came about because of the coincidence of overly lax policies on the part of some countries, but (because of its size) largely the US, and overly austere policies on the part of some other countries, particularly China (again, because of size), and also the oil exporting countries in 2005-7. Overly lax policies led to large current account deficits because expenditures exceeded income with resulting dissaving, while overly austere policies led to very low consumption rates and very high savings relative to income. By definition, the current account balance is the difference between domestic public and private saving and domestic public and private expenditure (including consumption and investment).

In normal circumstances, when a country continues to run large current account surpluses or deficits, there is quick feedback to policy makers that the policies are harmful. Flexible exchange rates can insure that import and export prices and quantities adjust somewhat, although without adjustment in the underlying savings/expenditure behaviour the offset will ab best be very partial

But even when exchange rates are fixed, there are normally strong pressures to adjust. In the case of surpluses, inflation rises as it becomes increasingly difficult to sterilise foreign exchange inflows. In the case of deficits, foreign borrowing increases and debt servicing payments rise. This is both because of larger debts and because of interest rates increases as debt rises relative to GDP and to other variables indicative of ability to pay. If monetary and fiscal policy remain lax enough to sustain continued imbalances, inflationary pressures also intensify in deficit countries, especially for goods (such as housing) that cannot be readily imported. In either case, pressures to alter policies to reduce the magnitude of the current account deficit or surplus mount, and policy makers usually respond.

But in the past decade, the two large blocs, one saving "too much", and the other "saving too little", offset each other. The combination of the high savings syndrome in China (and a few other countries) and high expenditures in the US meant that each country was an "enabler" of the other. The US became the "spender of last resort" while China was the "saver".

Thus, the normal pressures that accompany large unsustainable balances, positive or negative, were greatly weakened. There was little or no pressure on prices in the US, and interest rates did not rise. Likewise, China was able to sterilise capital inflows and accumulate reserves with little effect on the domestic price level. The housing boom in the US and some other countries might have happened anyway; and new financial instruments would in any event have developed. But the boom would have been less pronounced then. Hence, signals that would have led the Federal Reserve to tighten monetary policy were not there, and the absence of price pressures in China did not signal the need for tightened policies there, nor did price increases lead to real appreciation of the Chinese yuan that would otherwise have happened. Without the global imbalances, the downturn, if and when it came, would surely have been much less severe.

Turning that proposition around, however, had the housing boom, the carry trade, and development of new financial instruments been dampened through other policy instruments while real interest rates remained low, global imbalances might have lasted longer, but the downturn would surely have come even if would not have been quite as severe.

Policy responses to date

Nothing has been done to address the factors underlying global imbalances. The US still runs an estimated structural deficit (i.e., the fiscal deficit that would result when economic activity was at normal levels) of about seven and a half percent of GDP, while China is clearly still saving a very high fraction – more than 50% – of income. Most economists believe that an appropriate fiscal policy is one that

is balanced over the cycle, and hence is approximately zero when there is full employment. In the Chinese case, an appreciated real exchange rate would help to increase domestic consumption, but so, too, would measures that reduced incentives for saving (by enterprises as well as individuals) in the economy.

Measures taken to reduce the attractiveness of risk-taking by financial institutions (through increased capital requirements for financial institutions, through improved incentives for their managers, and through appropriate regulation) may mean that it will take longer for global imbalances again to build up, or that they are somewhat less extreme and lead to a milder crisis, than was the case in the build-up to the last one. But as long as the underlying expenditure-savings patterns of the two sides remain relatively unaltered, it is only a matter of time before the unbalanced world economy tips into crisis again.

The G20 have recognised the problem, and asked that countries submit their macroeconomic programs to the IMF, with the stated intent of using "peer pressure" to resolve imbalances. But, as Keynes long ago recognised, and as the management of the IMF experienced in the 2005-6 period, peer pressure is a very weak reed.

IMF efforts at coordinating responses to imbalances

The IMF had been pinpointing global imbalances, and pointing to their unsustainability, since the middle of the decade. In 2005, the then Managing Director of the IMF, Rodrigo de Rato, called for consultations among the major global players, including China, Japan, Saudi Arabia (representing oil exporters), and the US. IMF staff met individually with the policy makers in each of the key countries, including especially China and the US, to focus on imbalances.

All participants agreed that there were imbalances, and that their continued existence posed a threat to the stability of the world economy. There was little disagreement as to the magnitude of the required adjustments between representatives of the countries and the IMF staff.

When it came to discussions of how global imbalances should be resolved, however, each deficit participant insisted on the need for the surplus countries to adjust, while each surplus participant viewed the problem as the responsibility of the deficit countries.

One can, of course, hope that future "consultations" and peer pressure, as proposed by the G20, will induce the needed adjustments. To date, however, there is no evidence of that happening. Even within the European Union, where there were potential (albeit not large and not exercised) penalties for violation of the Union's fiscal rules, the rules were violated. And to date, the American Congress continues to focus on "penalties" for the Chinese in the event they do not adjust, while the Chinese continue to insist that America's current account deficit is the Americans' problem.

Need for coordinated adjustment

What is clearly needed is adjustment on both sides. Should one side, say the US, unilaterally attempt to reduce its fiscal deficit and provide incentives for greater private savings as well, the rest of the world would find itself under deflationary pressure unless offsetting measures to increase spending were taken elsewhere. The obviously place to take them would be China (and, to a lesser extent, a few other countries).

Similarly, should China reduce her savings rate significantly, the US and other countries incurring large current account deficits would face pressures of rising real interest rates and domestic inflation.

Coordinating the world's adjustment is therefore highly desirable, and the IMF is the logical place to do it. The problem, however, is that, beyond exhortation and the sorts of pressures tried by the IMF in 2005-6, there is little that the IMF, or the G20, or any other organisation can do without an enforceable international agreement as to how prospective imbalances might be measured, what adjustments would be needed over what period of time, and what sanctions might be applied in the event that the policy measures leading to these adjustments were not taken.

Issues to be addressed in devising an enforceable coordination procedure

But attaining that agreement is daunting. A first problem is that there is no agreed-upon metric for estimating what a "desirable" or "sustainable" current account balance is. Some countries with good policies may have excellent investment opportunities and be able to utilise large capital inflows for a period of years (South Korea had capital inflows of more than 10% of GDP for the better part of two decades and yet the rate of return on investment was sufficiently high that the debt-service ratio did not rise); other countries may be capital-abundant with low real rates of return to capital and benefit by investing abroad.

Even if agreement could be reached on estimates of desirable current account balances (presumably over the medium term), a next challenge would be to delineate the combination of policies that might bring about the adjustment, and to be able to allow for deviations based on cyclical factors, external shocks, and other unanticipated disturbances. The choice of which combination would be appropriate could be made by each country, although, of course, there would need to be agreement that the chosen combination would, barring unforeseen events, achieve the desired outcome.

Even if that were accomplished, there remains the difficult issue of sanctions for failure to comply. A number of possibilities come to mind, although the political feasibility is greatly in doubt. One possibility is that all countries might impose taxes on the new debt or on all new financial instruments issued by debtor countries in the event that deficit countries did not undertake the agreed upon measures. Similarly, countries might impose taxes on all imports from, and

subsidies on all exports to, a surplus country that did not apply the agreed upon measures. Such taxes and subsidies would have to be at a uniform rate, applied by all other countries, and the rate could be ratcheted upon or downward as compliance increased or diminished, and/or as time passed with inaction.

A second possibility might be financial penalties along the lines of those envisaged in the European Union for surplus and deficit countries. But such an approach would require a rule, or formula, the devising of which would pose a formidable challenge.

The outlook

In one way or another, the world will have to reach agreement on a mechanism to avoid extreme global imbalances. Whether that happens because of lessons learned in the current crisis, or whether it takes another crisis before the policy community is motivated to action is still a question.

Of course, while it is doubtful, there is a possibility that peer pressure will work – at least for a period of time. There is also a possibility that China, the US, and other countries will magically adjust as if coordinated, and that the coincidence of large "enablers" of both deficits and surpluses will not simultaneously arise again, at least in the next decade or so.

But in light of the serious consequences of imbalances, it is foolhardy to rely on the chance coincidence of domestic political needs inducing offsetting reductions and increases in expenditure. Equally, past experience with peer pressure does not give sufficient confidence that it can carry the day.

It may require another crisis, in order to convince all that the costs of accepting a global coordination mechanism would be substantially outweighed by the benefits of avoidance. But it is to be hoped that, despite the difficulties of establishing a global mechanism, enlightened leadership might rise to the challenge and develop coordination procedures in the aftermath of the current crisis. Given the costs of the past crisis, it is difficult to understand why such work has not yet begun, while memories are still fresh. Indeed, given the magnitude of the challenges in devising and agreeing upon an appropriate set of procedures and mechanisms, it will require many months of work to adopt an appropriate scheme, and even further time for its ratification by countries and its implementation.

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