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Global Imbalances and Financial Stability

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INTRODUCTION

Global Imbalances and Financial Stability

Overview

Over the past two years global attention has focused on the crisis in the euro zone. While generally discussed as a fiscal crisis, it was generated as much by the huge current account imbalances that developed within the euro zone. The euro crisis has diverted popular attention away from the more general problem of global imbalances.

However, the problem of large current account deficits in the USA and huge surpluses in a number of emerging market economies is far from solved. While officials in the USA and China continue to point fingers at one another concerning the causes of these imbalances, they generally agree that their international imbalances to a considerable extent reflect domestic economic imbalances and agree on a number of the types of policy actions needed to reduce these imbalances. But less progress has been made on the actual implementation of such policies.

The euro crisis illustrates vividly the interrelations among financial flows, current account imbalances and financial stability. The large current account imbalances within the euro zone could not have occurred without excessive flows of financial capital from the surplus to the deficit countries. In this case, the behaviour of financial markets aided the emergence of major disequilibria rather than providing discipline over public and private sector behaviour. The whole process was filled with excessive optimism and insufficient attention to the fundamentals until the crises came.

We are in serious danger of having a repeat of this unstable process at the global level. The dollar has remained strong during both the euro crisis and the preceding global financial crisis set off by the implosion of the US sub prime real estate market and its repercussions through the complicated set of financial instruments that were tied to it. As was illustrated in Europe, however, seeming strength can quickly turn to weakness and capital inflows can quickly reverse.

In Europe the trigger for the crisis was the unsustainable fiscal excesses of some of the member countries. The situation in the USA today is uncomfortably similar, with domestic political stalemates hindering efforts to bring the huge US fiscal deficit under control. Failure to do so will pose a substantial treat to global as well as US financial stability.

And even if a crisis is avoided the continuing current account imbalances are raising protectionist pressures that could escalate into a global trade war.

Thus we believe that this set of papers on global imbalances and financial stability is of great importance.

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Besides addressing directly such policy issues the papers raise a number of technical issues that are important for economic and financial research. These include greater attention to the dynamics of stock–flow interactions and the need to develop a better understanding of the behaviour of international capital flows. It is suggested that recent developments in behavioural and neurofinance and complexity economics should be helpful in this process. Also stressed is the need to pay greater attention to the composition and behaviour of national net asset positions and the important role of political economy considerations in dealing with international policy issues.

Highlights of the Papers

The first paper in our issue, by Graham Bird, gives an overview of the debates over global imbalances and presents a brief history of the policy discussions and limited actions that have been undertaken so far to deal with these imbalances. Both Bird (2012) and Willett and Chiu (2012), in the following paper, consider the argument, widely known as the Bretton Woods II hypothesis, that the large current account imbalances are not really a problem. Rather reflect the normal operations of the post Bretton Woods international monetary system where many developing countries seek export led growth and make use of the financial markets in the advanced economies, especially the USA, to compensate for their own underdeveloped markets. Bird (2012) and Willett and Chiu (2012) conclude that such analysis provides cogent reasons why the current account balances between the USA and the emerging market economies need not be reduced to zero, but that this does not imply that large current account imbalances are not a major potential source of instability in the international financial system.

In other words, global imbalances do present an important challenge to international economic and financial relationships. Continued large current account imbalances contribute to protectionist pressures in deficit countries and commonly generate a misallocation of resources in the surplus countries. In the deficit countries they allowed current spending to rise above sustainable levels which in turn raises the economic cost and political difficulties of adopting policies necessary to return to lower and more sustainable levels of spending. We are seeing these problems playing out in the USA and in the crisis countries of Europe.

The problems of a potential lack of sustainability apply especially strongly to the financing of continued large current account deficits. We have seen many examples that the optimism underlying large international financial inflows can sometimes evaporate quite quickly, giving rise to severe financial crises. While it used to be thought that such capital surges and sudden stops only occurred with emerging market countries, the euro crisis provided a stark warning that it can occur with advanced economies as well. So far the USA has escaped this outcome, but this is no reason to believe that the current situation is sustainable. The strength of the dollar in recent years cannot be taken as strong evidence that everything is under control.

Both Bird (2012) and Willett and Chiu (2012) emphasize that the current account imbalances facing both China and the USA are in substantial part a reflection of imbalances in their domestic economies. This has important implications for the heated debate about whether continued intervention by China to hold down the value of the Renminbi (RMB) represents a serious case of currency manipulation that has

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imposed grave harm to the global economy. The argument, popular in some circles in the USA, that if only China would revalue more the large US current account deficit would go away, just does not hold up to any kind of serious analysis. However, some economists have gone too far in the other direction, arguing that China should not appreciate at all. We must be wary of confusing the proposition that exchange rate adjustments alone are not sufficient with the argument that they, therefore, are of no help.

Bird (2012) reviews many of the proposals that have been put forward to deal with the global imbalances before they generate even more financial instability. He notes, however, that the past track record for achieving the types of policy co-ordination that are needed has not been encouraging. While some look back to the original Bretton Woods regime as a time of much greater policy co-operation than in today's world, its important to take note of Bird's conclusion that it has proven to be much less difficult to achieve agreement on co-operation on financing issues than for adjustment issues.

Willett and Chiu pick up on Bird's discussion of the political economy forces that hinder such adjustments. They discuss in some detail the recent developments in the literatures on political economy and international relations that are relevant to such issues, delineating a number of mechanisms through which they operate and showing how these apply both to the China–US imbalance and to those within the euro zone. They place particular emphasis on the problem of time inconsistency where short-term focused political pressures make it difficult to adopt policies which impose costs up front to avoid greater costs later on.

They make use of recent developments in the international relations literature on power relationships to argue that in the operation of today's international economic system, defensive power to avoid adjustments generally dominates positive power to force adjustments before crises break out. They argue that with the decline in countries' willingness to use military force for economic purposes, power has become much less fungible across issue areas. As a result countries may be weak in some policy areas and strong in others.

They conclude that China's huge accumulation of international reserves has given it considerable soft power with respect to such issues as the use of foreign aid and investments in raw materials producing countries, but that it has relatively little effective power to induce economic policy adjustments in the USA. While China does have the power to impose substantial costs on the USA by dumping dollars this would also impose substantial costs on China itself. Thus they argue that this Chinese–US relationship is one of mutual dependence.

Willett and Chiu also consider the role of international financial markets in imposing discipline over public and private sector behaviour. If financial markets operated according to the far-sighted rational expectations assumptions typically used in our international macroeconomic models, financial markets could be expected to provide strong and healthy discipline. However, in many recent cases including the Asian crisis of 1997–1998, the US subprime crisis and the euro crisis, financial markets have failed to behave in this manner. They echo Bird's observation that we do not know nearly enough about how international financial markets actually behave and argue that recent developments in behavioural and neurofinance, and complexity and imperfect information economics hold promise for helping us to develop a better understanding of the behaviour of financial markets and international capital flows.

Most technical discussions of global imbalances focus on the types of policy actions that will lead over the medium term to substantial reductions in current account imbalances. Hughes-Hallett and Oliva (2012) go beyond this time horizon and raise the difficult issue of the danger of longer term instability in the relationships between trade and capital flows. They analyse the effects that exchange rate rigidities and capital controls can have on the dynamic adjustment process and emphasize that some types of short-run correctives can lead to greater problems over the longer term. In the process of their modelling they introduce the important concept of "trade space" which is analogous to the concept of fiscal space used in the analysis of public finances.

In the final paper, Sun (2012) makes the important argument that discussions of global imbalances should not focus just on current accounts. He stresses the importance of net foreign asset (NFA) positions and argues that in some dimensions these are more relevant for economic welfare then current account imbalances. Current accounts are of course a major component of NFA positions and Sun finds that these positions are positively correlated but that the relationship is far from one to one. He also points out that many types of capital flows do not change NFA but rather change assets and liabilities together.

Recently heroic efforts by researchers such as Lane and Milesi-Ferretti and Sun himself have given us a much more comprehensive view of many countries' net asset positions and this has allowed study of the determinates of their behaviour. Sun uncovers a strong inverse U shaped relationship between countries' levels of per capita income and their NFA positions. Somewhat surprisingly these are negative for most high- and low-income countries and positive for middle-income countries. This holds across most types of international assets and liabilities. The exception is with securities where the level of development of domestic financial markets plays a major role. Sun also investigates empirically other determinants of NFA positions and finds that such factors as industrial structure, openness, inflation and levels of domestic financial market development are important.

Sun then turns to specific analysis of China. Given its level of per capita Gross Domestic Product (GDP) China has a well above average positive NFA position. This largely reflects its Foreign Direct Investment (FDI) to assets and securities to assets ratios. However, its debt to asset ratio is low. Sun argues that the composition of China's NFA position is heavily influenced by China's capital controls, but that these controls have had much less effect on its total NFA position. Over the longer term China's rapid economic development should lead to a reduction in its NFA, but based on Sun's empirical work, it is likely to continue growing for the next few years. Thus we cannot count on this process to provide quick relief from current imbalances.

Thomas D. Willett

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