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Global imbalances and the crisis

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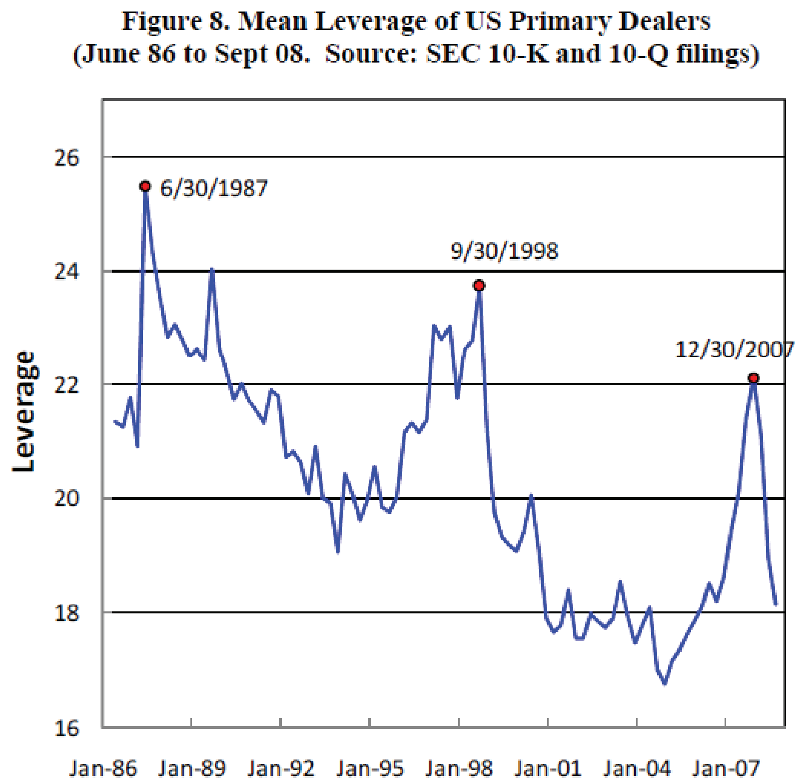
Road map

- Global imbalances (GI) caused crisis
- GI *interacted with* greed, incentive problems, financial innovation, weak regulation
- Policies: markets and imbalances
  - focus on regulatory reform misses GI – must deal with them
  - *provide credible insurance against 'sudden stops'*
  - exchange rates are not the central issue – in particular, not RMB undervaluation, nor German 'hypercompetitiveness' within euro area
- But macro imbalances are key to crisis within Europe too – analogous to GI

A conundrum: leverage in 'crises' – nothing special about 2007



Source: Adrian and Shin 2009

Why did the 'crisis' of autumn 1998 have no real effects?

- Leverage was actually *higher* then (!), and deleveraging was rapid
- But financial engineering hadn't yet developed the range of structured products that have proved so toxic
- Nor were they being held in 'off balance sheet' vehicles
- **And** there were *no global imbalances*

Disagreement on role of GI

- IMF: 'The crisis itself was not triggered by global imbalances.' O. Blanchard, *FT* 19.06.09
- A European policy-maker's view: '…global savings-investment imbalances have played a fundamental role [in origins of the crisis]…' L. Bini-Smaghi, Speech to Aspen Institute Italia, 23.06.09

An American academic view: 'The U.S. conceit that its financial and regulatory system could withstand massive capital inflows on a sustained basis without any problems arguably laid the foundations for the global financial crisis of the late 2000s. The thinking that "this time is different" – because this time the U.S. had a superior system – once again proved false... Capital inflows pushed up borrowing and asset prices while reducing spreads on all sorts of risky assets…'

C. Reinhart and K. Rogoff, *This Time is Different*

Global imbalances

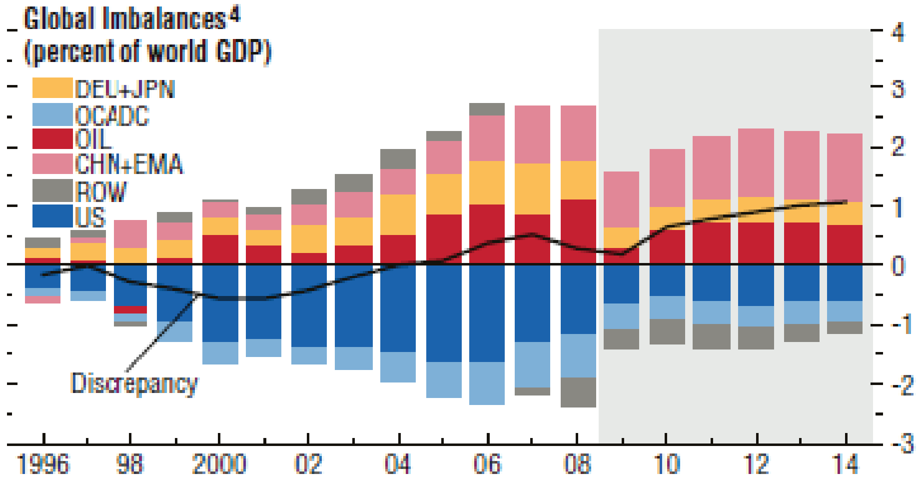
External positions of systemically important economies that entail significant distortions or risks (including instability) for the global economy.

- Current account (CA) flows – large surpluses and deficits
- Large net and gross foreign assets/liabilities
- *Distortions* from exchange-rate misalignments
- Relationship between external and internal imbalances
  - UK, UK household and government excess spending and *debt accumulation*
  - China, Germany, Japan inadequate domestic demand, Chinese *reserve accumulation*

GI: the issues

- Capital markets gave unlimited financing for CA deficits
- Increased *dispersion* of CA over the past decade – counterparts are much bigger *net and gross* capital flows, *putting pressure on intermediation*
- And loose monetary policies together with reserve accumulation brought excessive global liquidity
- *Not* just a US-China story: UK, southern and central Europe, Australia with large CA deficits; Germany, Japan, several Asian EM and commodity exporters with large CA surpluses

IMF: Global imbalances down, but forecast to rise again



Source: IMF staff estimates.
[1]China, Germany, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, Thailand, and oil exporters (including Islamic Republic of Iran, Nigeria, Norway, Russia, Saudi Arabia, and Venezuela).
[2]Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey, United Kingdom, and United States.
[3]Countries listed in Note 2, excluding United States.
[4]US: United States; DEU+JPN: Germany and Japan; CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand; OIL: Oil exporters; ROW: Rest of the world.

Source: IMF, *WEO*, September 2009

The problems

- GI a cause of fall of volatilities from 2004 to mid-2007 (financial market volatilities are a decreasing function of turnover and liquidity)
- Low volatilities, low interest rates, low inflation → *'search for yield'* and increase in leverage
- Search for yield created demand for financial 'innovation', met by issuance of 'toxic' securities
- And GI *capital flows overwhelmed financial intermediation system*

So the underlying problem was not – and is not – the failure of regulation

- Standard story → focus on regulatory reform…
- Stop subprime mortgages, high LTV ratios
- Curtail greed – caps on executive compensation, remedy incentive to stress short-term profits
- Regulate ratings agencies, hedge funds, private equity firms, derivatives markets
- Improve macroprudential regulation, make it countercyclical
- Cap leverage
- Remedy deficiencies of originate-to-distribute model

Yes, should do some of these things.

But 'financial excesses' are as old as financial markets.

And *if underlying global imbalances remain, they will continue to threaten stability – globally and in EU.*

Broader concerns looking forward

- Can the rest of the world do without US deficits?
- Must have rise in domestic demand in *surplus* countries, which requires they *accept fall, perhaps reversal of their CA surpluses.*
- This is *not* primarily an exchange rate issue, although exchange rates must adjust in medium term.

Policies: objectives

- Limit *both* GI and financial fragility
- But there are powerful forces behind 'deglobalisation', which policy should resist
- Avoid reversing financial development and financial integration

Policies: the markets

- Limit borrowing and leverage of financial institutions – would reduce demand for capital inflows, hence cut GI
- Control currency mismatches (especially household sector borrowing in foreign currencies)
- Develop EM domestic (local currency) securities markets
- If GI partly due to reduction of financial frictions, should policy create new ones – Tobin tax? No!

Policies: dealing with GI

- Provide *credible insurance* to countries that forego further reserve accumulation
- more central bank swap lines
- ‘reserve pooling’
- expand IMF resources, use flexible, fast-disbursing schemes with low conditionality – ‘liquidity insurance’
- Reduce focus on nominal exchange rate adjustment

Revaluation of the RMB is not the answer

- Large trade surplus with US and EU, growing FX reserves
- But large trade deficits with rest of Asia – Chinese exports to US substitute for other E Asian exports to US
- 20% *appreciation since 2005 hasn't reduced surplus with US*
- Estimates of ‘misalignment’ range from zero (Goldman Sachs) to 40% (Peterson Institute)! *We don't know ‘equilibrium’ rate.*
- Big ‘hot money’ inflows could turn around, and without capital controls, Chinese savers might switch into foreign assets
- Eventually China will need flexible exchange rate and flexible monetary policy, but financial system is fragile: go slowly!

Imbalances and the crisis in Europe: analogous to the global picture

- Periphery: household and government excess spending
- Germany: inadequate domestic demand
- German CA surpluses, capital flows from Germany to periphery
- Bubbles and toxic asset creation in periphery, where financial intermediation couldn't cope

EU response to crisis

- Initially, macro stimulus and regulatory 'reform'
- But that is a mess – for CRAs, hedge funds, private equity
- Finally, the crisis in Greece has drawn attention to macro imbalances
- But response so far is feeble and misdirected

Issues and policies for EU and euro area

- Macro imbalances – can Germany do without periphery's deficits? Again, this is not primarily an 'exchange rate' issue
- In CEECs, limit private sector borrowing in euros
- Liquidity insurance, but not Schauble's EMF
- Regulate markets properly – especially CDS
- But avoid reversing financial integration