Global Imbalances and the Need for An International Monetary System

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Introduction

The title I have chosen for my remarks makes reference to two things: "Global Imbalances" and the "International Monetary System". Let me begin with a few words to define each. It is important to be clear about definitions to avoid misunderstandings of the most fundamental kind. My basic point is that various kinds of international financial crises are now possible, with each being a manifestation of underlying deficiencies in the International Monetary System.

What do we mean when we talk about "global imbalances"? The traditional response would be that it refers to global current account imbalances and the associated build up of international debt imbalances. Such imbalances could in turn threaten large exchange rate movements with potentially disruptive effects on macroeconomic variables like growth and unemployment. Since, by definition, current account deficits and surpluses must be matched by offsetting **net international capital flows**, this traditional response implicitly says that net flows are the root of the problem. In particular, countries with current account deficits or large stocks of external net debt are likely to face balance of payments crises[1].

However, the global economy has changed greatly in recent years. As a result, many authors now suggest other meanings for "global imbalances" reflecting the belief that serious macroeconomic problems can arise from other international sources as well. Some have noted that **gross international capital flows** also have the capacity to inflict macroeconomic damage[2]. Therefore, they should be carefully monitored as well. Not least, valuation losses associated with borrowing

[1] As recently as October of 2014, the IMF's WEO warned that "Some larger debtor economies thus remain vulnerable to changes in market sentiment, highlighting continued possible systemic risks".

[2] A good example would be Borio C and Disyatat P (2011) "Global imbalances and the financial crisis: link or no link?" BIS Working Paper 346, Basel, May. See also Obstfeld M (2010) "Expanding gross asset positions and the International Monetary System" in "Macroeconomic challenges: The Decade ahead" Symposium organized by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August.

in one currency to support loans in another currency can wreak havoc on whole banking systems. We saw this during the South East Asia crisis of the late 1990's and a few years later in Argentina. Similarly, gross capital inflows into Japan in the second half of the 1980's ended in a massive crisis even though Japan had at the time the world's largest current account surplus.

Finally, a still broader definition of "global imbalances" might also be suggested. It means observing, at the global level, **substantial and sustained deviations of macroeconomic variables** from traditional norms that cannot be easily rationalized. Should such deviations revert to their mean, a global crisis might easily ensue. The BIS has been concerned about such "imbalances" at the level of individual economies for decades. However, in recent years the identification of extremely rapid rates of growth of credit and debt, often accompanied by rising asset prices, has been seen across a large number of countries. This suggests a common underlying problem arising from international real and financial linkages.

What is meant by the "International Monetary System"? Whatever the practical details, which are beyond the scope of these remarks, an International Monetary System would have one fundamental characteristic. It would be rules based. As with the gold standard and the Bretton Woods arrangements, the system would impose shorter term constraints on national policy actions with a view to providing significant benefits to all of its adherents over longer time frames. In particular, a system of rules would avoid the many dangerous shortcomings of the current non-system.

In the following remarks, I first look at the role played by "global imbalances" in the current crisis. I conclude that current account imbalances were not a problem at the global level, although they were of particular importance in the eurozone. Yet even there, they may have been more a catalyst for the crisis rather than the underlying cause. In fact, both in the eurozone and globally, very rapid credit growth (and associated debt accumulation) was the heart of the problem. Rapid credit growth almost everywhere contributed materially to the buildup of "global imbalances" as most broadly defined above.

I then turn to important deficiencies in the current International Monetary System. It is in fact a Non-System since there are no rules. It lacks an automatic international adjustment mechanism for current account imbalances. It allows massive "spillovers", including gross capital flows, from larger countries (especially the US) to smaller ones with potentially damaging implications. It is dangerously unanchored with respect to credit and monetary expansion, and it lacks an international lender of last resort. Crises will be repeated until we remedy these deficiencies.

A. Global Imbalances and the Current Global Crisis

At the global level, concerns have been expressed for many decades about the role being played by the US dollar as the primary reserve currency. Robert Triffin noted as early as the 1950's that the US would have to run current account deficits to meet the demand of foreigners for US dollar denominated assets. The buildup of external liabilities would, in the end, erode confidence in the dollar and a balance of payments crisis would follow.

The Bretton Woods system did indeed collapse but, in spite of the US running large and growing current account deficits for many years since, the dollar has continued to be the world's primary reserve currency. The size and unparalleled liquidity of US financial markets has undoubtedly played a big role in this, as has the increased "elasticity" of increased capital flows in a more globalized world. The willingness of large creditor countries to accept low rates of return and ongoing valuation losses, as the US dollar has trended downwards against their currencies, has also played an important supportive role.[3]

[3] See OMFIF (2014) "How Creditor States Lose Money" The OMFIF Commentary, 6 October. Also Ma G and McCauley R (2013) "Global and Euro Imbalances: China and Germany" in "50 Years of Money and Finance: Lessons and Challenges" Edited by Morten Balling and Ernest Gnan, SUERF (50th Anniversary Volume), Vienna. Since virtually all US debt is denominated in dollars, and all international assets of the US are denominated in foreign currency, declines in the value of the US dollar provide valuation gains for the US. Thus, the international net investment position of the US deteriorates far less over time than would be suggested by cumulating current account deficits.

Nor can the large US current account deficit in 2008 be held responsible for starting the current crisis. A sudden rise in the US risk premium would have seen US long rates rise and the dollar weaken. In fact, the very opposite occurred. In spite of the crisis having been "triggered" in the US market for subprime mortgages, US long rates fell sharply and the dollar strengthened. This pattern has been seen repeatedly at moments of rising tension in international capital markets as the dollar has continued to be treated as a global "safe haven". Indeed, capital flows of this nature have been designated as Risk On/Risk Off (RORO) flows, determined in large part by changes in international investors' appetite for risk.

Looking forward, however, there remains the possibility that concerns about the rising level of the US external liabilities will eventually come to weigh more heavily on the dollar. Just because something has not happened does not mean that it cannot happen. Indeed, the longer necessary adjustments are delayed, the more disruptive the eventual adjustment is likely to be. The likelihood of this happening will also be increased if the US fails to rise to its longer run fiscal challenges, raising fears of fiscal dominance of monetary policy. This likelihood would be further increased if the Federal Reserve were to appear complicit in such a process, raising fears of inflation and dollar depreciation at the expense of foreign creditors. Conversely, if the status of other potential reserve currencies were to be judged even worse, that could provide continuing longer term support for the dollar –faute de mieux.

One geographical area where current account imbalances have contributed significantly to the crisis atmosphere has been the eurozone. Large scale capital flows from core countries to peripheral ones cumulated from the middle 1990s until the eurozone crisis started in 2010. Interest rates converged on German levels in spite of member countries having widely different levels of both domestic and international debt. On the one hand, this may have reflected a mistaken analytical assumption – that countries in currency unions cannot have balance of payments problems. On the other hand, it might have reflected the

view that private sector creditors would always be bailed out by the public sector[4].

In the event, capital inflows to the peripheral countries led to a loss of competitiveness and large current account deficits. The euro zone crisis erupted when investors (and financial regulators) began to evaluate counterparty risk more carefully. When the previous capital inflows started to reverse, massive recessions set in as domestic "absorption" had to be dramatically reduced. This episode clearly illustrates that current account imbalances should still be a source of concern to policymakers, although evidently not the only concern.

Both at the global level and in the eurozone, it is worth asking about the underlying causes of the crisis, rather than just the proximate "trigger". I suggest that both crises had their roots in too easy monetary conditions in most of the advanced market economies but especially in the United States. The effects of this on rates of credit growth, and its increasingly low quality, were exacerbated by the growing elasticity of the financial system.

It must be added that the emerging market economies also contributed to the crisis. As their currencies tended to appreciate, even prior to 2007, most resisted vigorously in response to a variety of motives. These included fears of a loss of competitiveness as well as a desire to avoid disorderly and excessive exchange rate movements. Resistance took the form of both foreign exchange rate intervention and monetary easing. The former eased credit conditions in advanced market economies (as accumulated reserves were reinvested), while the latter eased credit conditions in the emerging markets themselves. Again, we see strong cross border linkages.

Since the onset of the crisis, there has been a great deal of regulatory restraint, and indeed fiscal restraint in some cases. Unfortunately, this has left monetary policy as the "only game in town" to help restore global aggregate demand. As a result, monetary policy in the advanced economies has continued to be

[4] For a discussion of these issues see Sinn H-W "The euro trap" (2014) Oxford University Press,

enormously expansionary, albeit through unconventional policy instruments[5]. Moreover, faced with perceptions of a "currency war", the resistance of emerging market authorities to exchange rate appreciation was even more vigorous than before the crisis began. Fears of valuation losses on already large stocks of foreign reserves might have been a further motivating factor[6].

The results have been relatively predictable. While inflation has not been a recent problem in the advanced market economies, there has been a resurgence of inflation in many of the emerging market economies. Further, many of the "imbalances" seen prior to the onset of the crisis have either not diminished or have actually worsened. Stock prices and yield spreads (along with the Vix) were at record highs and lows respectively by mid 2014. Credit standards have slipped in many areas in response to the "search for yield". House prices in many countries are also at record highs as are household debt levels.

Moreover, the reach of these imbalances has become global with emerging market economies increasingly part of the problem rather than part of the solution. Most tellingly, the ratio of non financial debt to GDP in the G 20 was twenty percentage points higher in early 2014 than it was in 2007[7], with much of the post crisis increase happening in Asia and Latin America. Corporate bond issues have surged, with many denominated in foreign currency. In short, we continue to have serious "global imbalances", using each of the definitions of this term defined in the Introduction to this paper

[5] This was deemed necessary since policy rates in most large advanced economies reached the Zero Lower Bound almost five years ago.

[6] Larry Summers once referred to this as the "balance of financial terror". Intervening, resisting appreciation, and accumulating more foreign exchange reserves avoids near term losses but raises the expected losses going forward as the stock of reserves grows larger.

[7] The BIS was first to point this out. See the BIS Annual Report (2014), Basel. For a much more detailed elaboration of the global nature of the problem, see Buttiglione et al (2014) "Deleveraging? What Deleveraging" 16th Geneva Report on the World Economy, ICMB, Geneva.

This brings me to a fundamental point. This never would have happened had there been some set of international rules to govern the behavior of national governments and national central banks. Consider, for example, if the United States had been forced by international rules to respond to its ever widening trade deficit prior to the crisis. Would not tighter US monetary, fiscal and regulatory policies at the time have helped avoided the worst of the "global imbalances" that now threaten us? Similarly, had China been forced earlier to let the renmimbi rise, would this too not have been helpful in stimulating consumption and curbing both exports and investment in fixed capital. All of these outcomes have long been declared desirable by the Chinese authorities.

B. Why We Need an International Monetary System

As noted above, an International Monetary System needs to be rule based. Such a system is required to avoid the many dangerous shortcomings of the current non-system. These shortcomings are discussed below.

1. The absence of an automatic international adjustment mechanism

In principle, countries with large external debts and/or current account deficits should face downward market pressures on their currencies. This should then encourage a shift of production to the satisfaction of foreign demand. Policy measures should then be used to reduce domestic "absorption" to make room for such a shift. The opposite set of forces should be in evidence for large surplus countries. This would allow an orderly adjustment to occur, preempting the buildup of still larger imbalances eventually ending in crisis.

In our current world, none of these forces need be seen. Free floating is thus "nothing but an illusion"[8]. For a start, exchange rate movements seem to have little to do with respective debtor/creditor relationships. Indeed, driven by "momentum trading", exchange rates can deviate for years from levels that might

[8] See Padoa-Schioppa T (2010) "The Ghost of Bancor: the Economic Crisis and Global Monetary Disorder" Lecture at Louvain-la-Neuve, 25 February, p.7

be consistent with underlying "fundamentals". The post crisis observation of Risk On/Risk Off behavior has had a particularly unfortunate consequence. It has implied a stronger dollar during long periods of Risk Off, which is inconsistent with external rebalancing. Further, exchange rate changes do not always, or at least not quickly, induce the shift in production capacity desired. Consider, for example, the recent depreciation of the Yen and the Pound Sterling which seem to have had very little real effects.

Nor need domestic policies reflect a countries external position in any way. For example, the US is the world's biggest international (net) debtor. Yet there is no impediment to it responding to periods of weaker overall demand with still more domestic demand stimulus, again interfering with the desired external adjustment. Similarly, Japan is the world's largest international creditor (with China second) while Germany has the world's largest current account surplus (all as percentages of GDP). Yet there is no impediment to all three countries responding to weaker overall demand with efforts to expand exports even further. With Chinese investment (particularly in property and construction) now weakening, it will be interesting to see whether the authorities respond by increasing export subsidies and by encouraging the renmimbi to depreciate. It cannot have escaped Chinese attention that the depreciation of the Yen, in the context of "Abenomics", atttracted no international criticism from the G20.

2. "Spillovers" from the monetary policies of large AMEs are disruptive

The easy monetary policies pursued by the Federal Reserve in recent years would traditionally have been described as the exporting of US "deflation" to others via a lower US dollar. Yet, in recent years, Rey, Shin and others[9] have suggested that what the Fed's policies are actually exporting is "inflation" and other credit driven

[9] See Rey H (2013) "Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence" Paper prepared for a Symposium organized by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August. Also, Bruno V and Shin H S (2012) "Capital Flows and the Risk Taking Channel of Monetary Policy" BIS Working Paper 400, Basel, December

imbalances. The mechanism through which this is said to happen warrants attention.

First, with low rates in the US and many international loans denominated in US dollars, longer term rates in other countries are increasingly correlated with US rates. Thus, there is a direct, stimulative effect on spending in other countries which affects the prices of currently produced goods and services as well as asset prices. Indeed, Rey (2013) goes so far as to say that only capital controls can restore a modicum of monetary policy autonomy.

Second, monetary stimulus reduces perceptions of risk (Risk On) and this lowers the Vix. This in turn (by reducing VaR) induces more leverage by banks with global reach. Banks respond to interest rate differentials with capital inflows into countries with higher yields, though this was more a pre crisis than a post crisis phenomenon. Increasingly, international capital flows are dominated by asset management firms who buy bonds issued by corporations in emerging markets. A large proportion of these bonds (especially in Latin America and South East Asia) are issued in off shore centers and denominated in dollars. These inflows, together with policies designed to hold down the exchange rate, threaten both inflation and the importation of imbalances as described above. Evidently, the possibility of sudden outflows (herding?) and currency mismatches threatens other problems as well.

Third, a final possibility is that easy monetary policies in the large advanced countries directly raise commodity prices. This hypothesis continues to be debated, and rests on the assumption that commodities are increasingly treated as a financial asset class whose returns have low correlations with other financial assets. However, if true, the implications are pernicious. Energy and food in poor countries are a large part of the consumption basket. To the extent these products are subsidized by the government, higher prices also cause a deterioration of the fiscal situation. These sorts of developments often have social and political implications, as was perhaps in evidence at the beginning of the

"Arab Spring". Evidently, this story is still playing out, perhaps with much greater eventual consequences than those seen to date.

Those prepared to admit that "spillovers" can be significant, propose a number of ways in which affected countries can protect themselves. In effect, these suggestions come down to trying to cut each of the links in the transmission mechanism just described. First, use regulatory means to reduce the use of leverage by banks with global reach. Closely related, use regulatory means to control the **outflows** of capital by large asset management firms. Second, let the exchange rate rise more. Third, use capital controls to prevent **inflows**. Fourth, mitigate the implications of such inflows through the use of macroprudential policies. In recent years, the IMF has actually endorsed many of these suggestions; not least the recourse to capital controls and the more vigorous use of macroprudential policies.

These suggestions might well be helpful, though it needs to be added that each has well known downsides as well. Not least, regulations, capital controls and macroprudential measures are all porous, involve significant distortions in free markets, and lose their effectiveness over time. As for allowing the exchange rate to take more of the burden of adjustment, this would seem very sensible. At the same time, the failure of the theory of uncovered parity to hold (except over very long time periods) implies that a "freely floating" exchange rate could move a very long way under the influence of momentum trading. In short, there are no magic bullets here.

Still more fundamentally, the practical use of such measures will demand enormous technical skill on the part of policymakers if they are to be effective. Idiosyncratic judgements will have to be made about which initiative might work best in different countries. Generally speaking, such skills are lacking. In any event, all of these measures smack of "sauve qui peut" and "chacun pour soi", hardly a systemic response to an underlying systemic problem.

3. The current “non-system” is dangerously unanchored

If one constructs a global Taylor rule, the actual policy rate has been systematically below that prescribed by the rule for the whole period between 2002 and 2012. Similarly, in a Wicksellian framework, global measures of the “financial” real rate fell below similar measures of the “longer run natural rate” (potential global growth as estimated by the IMF) in 1997 and have generally widened since. These measures give prima facie cause for concern that the global economy is on a dangerous path[10].

Today, monetary policy continues to be aggressively expansionary almost everywhere. This is particularly the case in the US, which remains the “anchor” of whatever system is left. Moreover, the Federal Reserve sets its policies solely on the basis of the expected implications for the US. The “spillover” effects on other countries play no role in the Fed’s decision making process. This is not only unfortunate for those countries affected by the “spillovers”, but it might also be unfortunate for the US itself. Countries outside the US now account for a much larger share of output than, say, twenty years ago. Thus, problems like rising inflation and growing imbalances elsewhere could more easily feed back on the US in turn. Even were the Fed to be interested in such issues, the complexity of the feedback effects almost defies policy prescriptions at the level of individual countries. We simply have no idea what might be the end result of current monetary policies for the global economy.

There is now a burgeoning literature (including contributions from the BIS and the IMF) on “measuring global liquidity”[11]. This is certainly a welcome development in that a top down approach internalizes the interactions between economies. What remains unaddressed is the control mechanism, at the global level, were it to be

[10] Hannoun H (2012) “Monetary Policy in the Crisis: Testing the Limits of Monetary Policy” Speech delivered at the 47th SEACEN Governor’s Conference, Seoul, Korea, 13-14 February

[11] For examples see IMF (2014) “Global Liquidity: Issues for Surveillance” Washington DC 11 March and Eickmeier S et al (2013) “Understanding Global liquidity” BIS Working paper 402, Basel, February. It is notable that this was also the general topic for discussion at the Jackson Hole meetings in 2013.,

felt that the growth rate of global liquidity were either excessive or inadequate. Some have suggested an internationally coordinated monitoring process to assess the effects of national monetary policies on others[12]. This might lead, for example, to coordinated interest rate increases that would minimize the dangers of unwelcome exchange rate fluctuations. However, what is also needed is an assessment of whether a rule based International Monetary System might not be better still.

4. No adequate sources of international liquidity should crises occur.

The available resources of the IMF to support countries with balance of payments difficulties would prove totally inadequate were a number of small countries to get into trouble simultaneously, or even just one big one. In the absence of adequate public sector financing, a withdrawal of private sector financing would demand disabsorption to the point where the current account deficit effectively disappeared. As in the case of Indonesia in the late 1990's, this could be extraordinarily painful. The more recent experience of deep recessions by some of the peripheral countries in Europe is also relevant, even if the required adjustment there was cushioned to some degree by "Troika" money and the workings of the Target System for international payments within the euro zone.

It is true that, in the early days of the current crisis, the US Federal Reserve opened swap lines that made US dollar reserves available to a number of countries. Not of least importance, many European banks suffered a loss of US dollar liquidity as earlier funding sources in the US (especially money market mutual funds) essentially dried up. Nevertheless, the countries that benefitted were limited and the criteria for choosing them were opaque and chosen by the Fed rather than the international community. In addition the extension of the swap lines was for a limited time only. While they were put on a permanent basis in October 2013, all the other shortcomings remain.

[12] For example see Committee on International Economic Policy and Reform (2011) "Rethinking Central Banking" Brookings Institution, Washington DC.

If countries feel they cannot rely on the Fund for adequate liquidity support during crises, it is not surprising that they seek “self insurance” through reserve accumulation. The problem of course is that such accumulation contributes to holding down the value of appreciating currencies which in turn raises the likelihood of rising inflation, other imbalances and subsequent crisis. In effect reserve accumulation increases the capacity to deal with crisis but makes such a crisis more likely. As well, countries are tempted to resort to regional “mutual support” exercises (like the Chaing Mai initiative) which erodes the sense of global solidarity and could, in practice, lead to significantly less conditionality. More moral hazard, in a world awash in moral hazard, hardly seems optional. A global solution to this problem would therefore seem highly desirable.

C. Conclusions

In these remarks I have suggested several definitions of “global imbalances”. Each of them has the potential to end in crisis, either for individual countries or for the global economy as a whole. While domestic authorities might be thought capable of monitoring the buildup of such imbalances, and doing something about them, in practice such preventive feedback is generally absent. Net debtors, or those receiving large scale capital inflows, often lack the will to do what needs to be done. Net creditors, or those that are the source of large capital outflows, often contend that they have no interest in the matter (and certainly no responsibility) since any eventual crisis will emerge elsewhere.

An international monetary system that imposed responsibilities on everyone could play a significant role in reducing the dangers associated with the various definitions of “global imbalances”. Net debtors, or those receiving large scale capital inflows, would effectively import the will to do what needed to be done. Creditors too would be forced to play a role, consistent with the recognition that crises do not just affect the debtors and the importers of capital. When those with liabilities cannot pay, those with assets do not get paid. This simple but uncontestable fact underlines the need for a systemic international response to what has become a dangerous set of systemic problems.