PART 2: What are the systemic costs of imbalances?

5 The costs of global imbalances

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As global imbalances have receded among policymakers' priorities, this chapter warns they are no less a systemic threat to financial stability in the medium and longer term. Moreover, while deficit countries may accumulate unsustainable external debts, surplus countries face the unpalatable choice between inflationary pressures and extensive sterilisation. Policymakers should thus return with renewed vigour to implement the Pittsburgh framework

The global imbalances have receded among policymakers' priorities. Financial regulation has generated an epic legislative and lobbying battle in Washington as well as Europe, with significant transatlantic differences. Bank tax proposals have divided the G20. The sovereign debt crisis in the Eurozone has been at the top of macroeconomic policy concerns. Current account deficits and surpluses may seem less important. But they are no less a threat to financial stability in the medium and longer term.

The global imbalances are set to rise. The April 2010 World Economic Outlook probably understates the future pathThe latest OECD outlook suggests that the sum of absolute values of current accounts as a percentage of world GDP will go back to about four-fifths of its 2007 level. The OECD baseline scenario shows the US current account deficit rising again to over 4% of GDP, with the Chinese surplus at 4%. The latter is again likely to be an underestimate. Chinese exports have been rising very sharply recently. Even if China allows some flexibility in the dollar-renminbi rate and it appreciates somewhat, this is likely to have only a small effect on the Chinese surplus.

Moreover, the euro is falling against the dollar, and the US is likely to recover faster than Europe. So the euro area and Chinese (more broadly, East Asian) surpluses will rise, and the US deficit will rise. The main uncertainty is the oil price and the surpluses of energy exporters, but the price is unlikely to fall from its current level, so those surpluses will continue. Note also that the OECD argues that fiscal consolidation alone would have little effect on the global imbalances.

There are few truly exogenous variables in economics. The costs of the global imbalances are costs associated with the factors that create them. These too are all endogenous. But the focus would be on savings-investment imbalances and exchange-rate misalignments. In China, we see an extremely low share of household disposable income in GDP, but despite this, high household savings ratios, as well as high corporate and government savings. There are signs of

serious pressure for major wage increases in China, and if these were generalised, they could have a substantial effect on household consumption, but it is too early to forecast this with confidence.

Germany too has low household consumption relative to GDP. The US, on the other hand, has a very large government deficit and relatively high consumption. US household savings ratios, which had risen somewhat with the crisis, now seem to be falling again.

Gruber and Kamin (2008) forcefully contest the view that imbalances arise from cross-country differences in financial development or the attractiveness of financial assets. And their view is consistent with the imbalances within the Eurozone and their consequences. Germany's financial system is not less developed than those of Ireland, Italy, Spain and Portugal. But the position of Germany in relation to these countries is otherwise analogous to that of China in relation to the US – the same macroeconomic differences, similar current account and capital flow patterns, the same dire consequences.

By far the major systemic cost of the global imbalances is the continuing threat they pose to financial stability. I have argued that global imbalances were the fundamental cause of the crisis (in Dewatripont et al., 2009). They interacted with the weaknesses of the financial sector, to be sure, but many of these long pre-date the developments of the period 2004-2007. The huge capital flows associated with the global imbalances simply overwhelmed the capacity of even the most sophisticated financial systems to intermediate them. And these capital inflows continue to make US markets very liquid, to keep interest rates down, and thereby contribute to underpricing risk (see also Bini-Smaghi 2009, Obstfeld and Rogoff 2009, Reinhart and Rogoff 2009[1]). Again, German capital flows to the 'peripheral' countries of the Eurozone went to financial systems that could not intermediate them effectively and safely.

Everything is endogenous, so we cannot say that global imbalances 'cause' prolonged exchange rate misalignments, any more than those who blame undervaluation of the renminbi can claim that this is the cause of the global imbalances. Nor is it as obvious as many would argue that the renminbi is indeed significantly undervalued relative to some 'equilibrium' rate. But if exchange rates really are far from long-run equilibrium rates, we can count another systemic cost of the associated global imbalances: distortions of investment allocation both across and within countries.

Globally, capital exporters have been poor countries with high marginal productivities of capital (although Germany and Japan do not fit this story). The intermediation process has not channelled emerging market savings into emerging market investment, but rather into consumption and government expenditure in rich countries. Within countries, overvalued (undervalued) exchange rates generate overinvestment (underinvestment) in non-tradeables. Such distortions can have major long-run consequences.

1 A representative quote is, 'The US 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 UShad a superior system – once again proved false... Capital inflows pushed up borrowing and asset prices while reducing spreads on all sorts of risky assets…' (Reinhart and Rogoff, 2009)

If the global imbalances do settle even at the lower level forecast by the OECD, i.e., only 20% lower than in 2007, there will be growing trade tensions. So far, the G20's emphatic stand against protectionism may have had some effect. Although each of the major G20 countries has introduced significant trade restrictions since 2007, they have been limited relative to what had been feared.[2] But if the US trade deficit and unemployment both remain stubbornly high, this restraint is unlikely to continue. The calls for antidumping duties and other measures against China, in particular, are getting louder and more widespread by the day. US protectionism could get nasty. If the euro does continue to fall, however, there will at least be less protectionist pressure in the EU.

If the US deficits do rise, American growth rates do not recover strongly, interest rates rise in due course, and the dollar does not depreciate gradually, then the US' external debt dynamics will again look unsustainable. The imbalances will then raise the danger of a future large, abrupt drop in the dollar), which could be very destabilising to the world economy. This was the crisis that many macroeconomists did fear (Ferguson et al., 2007, Krugman 2007), but it did not happen. It still could.

Finally, we have two symmetrical problems for individual surplus and deficit countries. The former accumulate excess foreign exchange reserves. These have low yield and, for poor and emerging market countries, high opportunity costs. If the surplus country manages its exchange rate, it also faces the unpalatable choice between inflationary pressures and extensive sterilisation. Sterilisation typically has a high 'quasi-fiscal' cost, and forcing domestic banks to accumulate sterilisation bonds is not a way towards a healthy financial system.

Conversely, countries running sustained deficits – not just the US, but also, for example, some of the peripheral Eurozone countries – accumulate external debts. At some point, as for the US, these may appear unsustainable, and the markets will punish them.

Thus the costs of global imbalances are systemic and country specific, numerous, and very high. The imbalances are not benign reflections of underlying long-run equilibrium relationships. Policymakers should return with renewed vigour to implement the Pittsburgh framework.

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