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Comments on Adjustment of International Imbalances
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Emerging from the Financial Crisis
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*“Things that can’t go on forever, don’t.”
-Herbert Stein*

In these remarks, I want to address four questions: First, why did the remarkable pattern of global flows of capital of the 2000s emerge? Second, how did the US behave as borrower and spender of last resort? Third, what did this have to do with the financial crisis? Finally, what reforms do we need to consider, to ensure a better-balanced and less unstable global economy?

1. Origin of the “global imbalances”

In the 1980s and 1990s, the world was plagued by a series of massive financial crises in emerging economies. In many cases exchange rate crises and banking crises proved mutually self-reinforcing. The culmination came in 1997-98, with the Asian financial crises and the Russian and Brazilian crises.

A central feature of many of these crises had been a previous period of large current account deficits driven by investment booms and asset price bubbles. The deficits, in turn, were frequently financed by short-term foreign currency borrowing. So when the crises hit and the exchange rate collapsed, the currency mismatches created mass bankruptcy: the financial system and often large parts of the non-financial business sector became insolvent. The resulting economic crises were very deep and costly, in terms of lost output and the fiscal costs of recapitalizing the financial system. In Indonesia, for example, GDP declined 13 per cent in real terms in the first year and the fiscal cost of the bank bail out exceeded 50 per cent of GDP.

These were devastating experiences that had a significant impact on the policies not only of the affected countries, but also of other emerging economies. Many emerging economies, particularly in Asia, decided “never again”. They decided not to float their currencies freely, as most economists recommended, but to fix them at a “competitive” level. They then found themselves generating huge trade and current account surpluses. To keep the exchange rates down, they intervened massively in foreign currency markets. Between the beginning of 1999, just after the crises, and their peak in July 2008, global foreign currency reserves rose by about \$5.5 trillion, to close to \$7 trillion. With the exception of Japan’s, virtually all this increase in reserves occurred in emerging economies, with China the biggest accumulator of all. These reserves might be regarded as an expensive form of self-insurance against future crises. Most of the holders probably regard them as worthwhile in the current crisis.

In order to defend the currency intervention policies, the governments concerned had to sustain the savings that are the counterpart of current account surpluses. They did so via sterilization of the monetary impact, credit controls, budget surpluses and encouragement of high corporate savings. The irony is that they current crisis is at least partly the consequence of these policies, sometimes known as “Bretton Woods II”. It should be noted that this regime is inconsistent with either of the classical regimes: freely floating exchange rates or the gold standard. It is a mercantilist hybrid regime.

2. The US as borrower and spender of last resort

As a result of these policies, emerging economies started to run huge current account surpluses, with China being the most important single player, by far. A number of high-income countries – Germany, Japan, Taiwan, Singapore, Switzerland – also continued to run large current account surpluses and the oil exporters also started to run large current account surpluses, as the oil price rose. So somebody had to run the offsetting deficits. The most important “somebody” was the US, which imported about 70 per cent of the world’s surplus savings. Other “somebodies” were the UK, Spain and Australia. The surpluses peaked at 2.5 per cent of world GDP last year. Up to 2007, about 70 per cent of these surpluses were absorbed inside the US.

It was concerned with two consequences of these “imbalances” for the US: rising external debt; and rising household debt. It turned out, somewhat to my surprise, that external debt was well contained by the extremely low returns foreigners received. What made the external deficits safe for the US was that US assets were pretty bad investments for the investors. Internal debt was a different matter, however. The environment of low real and nominal interest rates, house-price bubbles, soaring credit and financial innovation created extraordinary financial vulnerability inside the US and global financial systems. At its peak in 2005, the financial deficit of the US household sector reached 4 per cent of GDP, an unprecedented figure, as household consumption soared to over 70 per cent of GDP. Household debt jumped from 66 per cent of GDP in 1997 to 100 per cent a decade later. Financial sector debt jumped from 64 per cent of GDP to 117 per cent over the same period. This then was a huge borrowing binge.

The imbalances can be seen as the product of either a “savings glut” or a “money glut”. My own view is that the savings glut caused the money glut, by driving the Federal Reserve to pursue expansionary monetary policies, which then led to the reserve accumulations in the creditor countries. But it is also possible to view the Federal Reserve as the causal agent: the money glut causes the savings glut. Either way, the reserve accumulations and fixed exchange rates played a big role in the entire story.

3. Financial Crisis

The explosive increases in debt and the associated housing bubble could not last – and did not do so. When the bubble burst, bad debt started to emerge across the global financial system. Given the extreme undercapitalisation of the financial system, this started to create panics about solvency. As the panic spread and risk aversion grew, the financial crisis spread and reached its worst after the bankruptcy of Lehman. The crisis spread to every significant credit market, except for triple-A rated sovereign debt. In October 2008, the financial system effectively ceased to function.

4. Roads to reform

This big US adjustment that I believe must lie ahead is compatible with global growth only if other countries have smaller surpluses or bigger deficits than today. Non-oil

exporters also need to reduce current account surpluses or increase deficits. This means they must spend more relative to their incomes. China, the world's largest surplus country, is the most important single case.

So how are emerging countries to run current account deficits safely? The answer is that the external finance must itself be relatively stable. There are three solutions: Equity investment (FDI and portfolio); local currency bonds; and greater collective insurance – probably via the IMF.

The development of local-currency bond markets would shift a potentially dangerous risk from debtors to creditors. As important is a bigger global insurance system. The IMF's lending capacity is now about \$250bn. It is trying to double it, but it probably needs to be an order of magnitude bigger. That will also require a big re-engineering of voting shares. Today Europe has a third of the votes. That cannot last, particularly since the Europeans do not even use the resources of the Fund. It is one of the reasons why emerging countries are so averse to using the IMF's resources.

A still bigger question is the exchange rate regime. I am pragmatically in favour of floating. While I recognise that the gold standard did work well before the first world war, it is most unlikely to work now. It is true that the combination of a single key currency with floating exchange rates has indeed proved an unreliable way to transfer resources to emerging economies. But if countries choose pegs, they must stick by the rules: no sterilization. Yet that is what is now happening, on an enormous scale.

5. Assessment

This is a turning point for the world economy: we have reached the end of the US as borrower and spender of last resort; and we have reached the limits of the Asian export-led mercantilist model of growth. The reduction in internal imbalances inside the US and other deficit countries depends on reducing the external imbalances, while maintaining global economic growth. This demands big changes in the policies of the rest of the world and reforms in the global financial system