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Comments on Adjustment of International Imbalances
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ARE GLOBAL IMBALANCES GOING TO ADJUST IN 2009?

There is a today wider consensus than a few years ago about the fact that global imbalances have been mainly the result of a large saving glut in emerging economies rather than an excess of consumption in the US and other developed countries. In the 1990s, Latin American and Asian countries were importing massive amounts of capital from the rest of the world to finance their development. Latin America had a large debt crisis in 1994, which started in Mexico, and emerging Asia another one in 1997-98, which started in Thailand and Indonesia and spread in to other Asian emerging economies and then to Russia and Latin America. Both needed strong interventions by the IMF and the World Bank. After suffering this traumatic experience, most emerging economies started to save again and to build up large reserves to insulate themselves from any future sudden stop of capital inflows as well as to avoid similar crises in the future.

Since then, these large emerging countries saved foreign currency reserves have been financing the demand from developed countries consumers and investors and allowing some of the latter countries to build up large current account deficits, notably in the US, but also in other developed countries such as Spain, the UK, Australia, New Zealand and Italy and producing housing bubbles in some of them, such as Spain, the UK and Ireland. In any case, today, most of the largest current account deficits are held by small countries, both developed and developing, and mainly by small poor countries. Net lending in 2008 has been negative in advanced countries in -1.1% of GDP (a net outcome of Germany and Japan having a positive one of 7.3% and 4.0% of GDP respectively and the US having a negative one of 4.9% of GDP) while it was positive by 4.0% of GDP in emerging and developing countries, with the exception of central and eastern Europe where it was negative by 6.7% of GDP.

Large emerging countries were looking where to invest those excess savings in foreign currency in highly secured financial instruments, mainly in top sovereign bonds as well as triple A corporate bonds. As soon as investments in these free or low risk assets started to produce very low returns because of their massive purchases by emerging economies, US banks produced other high-grade asset backed securities (based on mortgages, consumer loans and other loans, which finally included sub-prime loans as well) to meet the emerging countries increasing demand for low risk assets. Many of these ABS and MBS were also triple A, but with a higher return than traditional triple A bonds (which by definition was an oxymoron) so that the US current account deficit continued to be financed by foreign savings and kept growing.

After August 2007, when the MBS and ABS Commercial Paper Market dried up because of rating agencies downgrading these collaterals (mainly MBS with subprime collateral), which produced a major blow to large commercial and investment banks which were originating and distributing these securities (but also investing in them) to emerging sovereigns and private investors as well as Europeans, Japanese and from other developed countries. When the crisis started, US and UK damaged banks were able to convince some sovereign wealth funds (SWF) to buy

their stocks, which later cause them very heavy losses. These investment failures made them to search, even more than before, for risk-free assets were to invest. As a consequence, after Lehman was allowed to go bankrupt and real panic developed among sovereign and private investors, these immediately bought even larger amounts of US Treasury bonds and bills thus helping to keep financing the US current account deficit further.

In order for these global imbalances to adjust, the US and other developed current account deficit countries would need to reduce their consumption and investment demand and to increase their savings while the rest of the world should increase its internal consumption and investment demand and reduce its savings. Nevertheless, although the US internal demand has been falling for more than a year, as a consequence of its housing and stock bubbles going bust after the financial crisis started, the propagation effects of these two adverse shocks into the rest of the world have been so large that today the world is witnessing an almost global synchronic slowdown, for the first time in history. Today, practically all OECD countries are in deeper recession than in any previous slowdown and the same is happening to a considerable part of the emerging countries.

Given that financial globalization is the one which is most advanced and capital and credit markets are highly integrated worldwide, the US financial crisis is affecting very negatively most global banks and most global investors, but mainly those which were highly leveraged. These countries have been suffering heavy losses in their financial portfolios of asset backed securities, of stocks, as well as of structured products and real estate assets, affecting negatively their balance sheets and producing huge write-downs and expensive capital increases in most global banks and many investor funds which, in turn, are those which are also producing a global credit crunch and a global slowdown. Total loss of wealth in the world by the falling prices of these assets is around \$35 trillion that is around 60% of global GDP.

Moreover, the financial crisis has created such a new and very serious situation of general lack of confidence in financial markets and their products and of a high uncertainty and panic, that world investors have fled even to more quality and invested heavily in those assets which are still considered to be the safest in the world, namely, US Treasury bonds and bills, allowing the US to continue to borrow cheaply and maintain a comfortably large current account deficit, while, in the meantime, most private stocks and bonds and other alternative investments have seen their prices falling further and more sharply. As a result of this general lack of confidence in financial markets that has brought the present growth slowdown, both developed and emerging countries' households and companies are increasing their savings even further which is, at the same time, producing a larger global slowdown. Thus, this larger saving glut is only helping to fulfil the first necessary condition for global imbalances to be reduced, that is, increasing savings in the US will allow for a reduction in its current account deficit, but is not helping the second necessary condition of reducing global imbalances, that is, increasing consumption and investment in the rest of the world.

Therefore, both the global saving glut is now even bigger and the search for safe assets is even larger than ever before, so that the US current account deficit is not only more easily financed than expected not only by the accumulated reserves of emerging countries, but also by savings from other developed countries which are also coming into the US looking for a safer refuge. This is the reason why the dollar has kept appreciating instead of depreciating, as it should be expected, and most currencies have been falling against the dollar. As a result, the US current account deficit is forced to be growing, because, by balance of payments accounting definition, where total balance needs to be zero, these new large capital portfolio inflows are producing a larger capital surplus and a consequence a larger trade and current account deficit.

Furthermore, protectionist reactions are appearing in many countries, both developed and developing and especially in those which are more globalized. The reason being that those countries which are most negatively affected are those which are more open to foreign trade and investment and which have reached a higher degree of globalization. Thus, anti-globalization attitudes in developed are coming back, which unfortunately, will only make depression more likely. A world depression could be the worst outcome possible, given that it will produce a large deflation in many countries which will suffer the well known debt deflation negative consequences, from which it is very difficult to escape as historical experiences and evidences have shown both in the Great Depression and in Japan.

The solution to this serious potential danger is for all large countries in the world to try to act together and, at the same time, to use taxpayer public money to increase internal demand for consumption and investment to compensate for the fall of private internal demand. This would mean that most developed countries would need to issue large quantities of new debt in order to raise their amounts of financial resources that they need to allocate to this countercyclical and anti depression policy. These large new sovereign debt issues will produce safer assets to meet the increasing demand from central banks reserves and sovereign wealth funds (SWF) from emerging and oil exporting countries so that their recycling of funds from current account surplus countries to current account deficit ones will keep global imbalances as usual.

But, in spite of all these facts, there is today a higher chance that global imbalances may be reduced in the next years. Given the exceptional size and depth of this global recession and the present need to avoid a global depression, most developed and emerging governments in the world are forced to bailing out their most damaged banks and to inject massive amounts of public fiscal resources into their economies to compensate for the fast drop in their private internal consumption and investment demands, (in a less coordinated form that it should be expected) given that their internal demand is falling very fast and unemployment is increasing in a similar way, reaching record levels in some countries.

If this trend continues, then oil exporting countries and emerging economies will allocate a large part of their reserves to domestic investments. China is the

country leading this trend, given that has already injected savings for a total of 12% of GDP into its domestic economy and it is ready now to double that percentage in a second round. Large oil and gas exporters such as Russia, the Middle East and North Africa are now also engaged in trying to prop up their own economies, to avoid social unrest and increasing demands for political change.

Thus, in the next few years it is highly probable that world savings will start being allocated and invested where they are more needed, that is, in the same emerging economies that are generating them, instead of being invested abroad in developed countries assets. Only the poor countries will have to be helped through international financial institutions, notably the World Bank, the regional development banks and the IMF, because most of them do not have enough domestic public savings to help their economies and have very large current account deficits. That is, most countries in the world are probably going to go through a temporary and strong re-nationalization of their own saving-investment markets (an even larger Feldstein-Horioka level of self-financing than during the 1970s) which will make it more and more difficult for current account deficit countries, such as the US, to finance them.

Which were the sources that financed the US current account deficit in 2008? At the end of 2008 there are not many data available about the way it was financed but it can be guessed using the IMF world flow of funds and some information from central banks and sovereign wealth funds. Central bank foreign currency reserves in emerging economies reached around \$7.0 trillion and SWF foreign currency reserves \$2.5 trillion, that is, \$9.5 trillion in total, around 17% of global GDP and 5% of total world financial assets. The US deficit has been around \$700 billion, sovereign wealth funds have invested in US assets around \$250 billion and central banks have invested around \$800 billion. Thus, only these two sources of funds from emerging economies have financed 135% of the US current account deficit.

But, in 2009, it seems clear that at the present price of oil and other commodities, it may be much more difficult for commodity exporting countries to finance the US current account as much as in 2008, where oil and other commodity prices including foodstuffs reached a peak. Now their prices are at a very low level due to the lower demand coming out of a world recession. It will be also rather difficult for exporters of manufactures such as China and of equipment goods and transport goods such as Japan, Germany, Korea and Taiwan to be able to accumulate reserves given the huge fall in demand for these goods worldwide except those created through keeping their own currencies depreciated in respect to the dollar.

Moreover, most emerging and oil and other commodities exporting countries need part of their reserves to be invested domestically to tackle their increasing fall in private internal and external demand. Therefore, an increase in US savings and a drop in the US dollar may be the two main ways by which the US can reduce its current account deficit because emerging countries foreign savings will be more focused in solving their own domestic recessions so that they will not be able, as in 2008, to over finance the US current account.