

Global Imbalances and the International Monetary System
Session 3 -- International Cooperation in Times of Global Crisis:
Views from G20 Countries

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We have heard three, wide-ranging papers. They address, in more or less detail, three topics: (1) the role of global imbalances in causing the 2007-09 global economic and financial crisis, (2) global imbalances in the next expansion, and (3) implications of the crisis and imbalances for reforming the international monetary system. I will discuss in turn each topic as addressed in each paper.

Role of Global Imbalances in the Crisis

There are four broad views of the role of global imbalances in causing the crisis: (1) global imbalances had nothing to do with the crisis, (2) were a marginal contributor, (3) were an important contributor to the crisis, or (4) were jointly caused by a common set of forces.

David Vines is in the third camp. He argues that loose US monetary policy “caused” the crisis and that global imbalances contributed more than marginally to the need for a loose US monetary policy. I have problems with both parts of his argument.

On the first part, I agree that US monetary policy was too loose for too long. This added to systemic risks in the form of relaxed lending and credit standards in financial institutions and among regulators and supervisors and led to a build up in leverage that

eventually came to a painful end, but the link from global imbalances is not established. Moreover, I missed a few empirical details in David's analysis. Where was Japan? Their interest rates have been essentially zero for a decade? Were the monetary, regulatory, and supervisory policies of other advanced countries neutral? The fact is that we had a global credit boom caused a relaxation in credit policies in many countries and extending well beyond the US housing market. The paper hints at, but does not address, these global aspects.

Moreover, David's theoretical argument about how the crash ultimately came about implies that in early 2006 the Federal Reserve had pushed interest rates too high too soon, once they got started, or had kept them high for too long. I do not think he really believes this argument, but that is how I read his paper.

On the second part of David's argument – how global imbalances caused the Federal Reserve to be too easy – the mechanism, as far as I can tell, is that loose US monetary policy failed to cause a significant decline in the dollar, which would have closed the US imbalance, because the RMB and some other currencies were pegged to the dollar. Therefore, the Fed had to pump up asset markets and the US economy to sustain the US recovery and growth.

The factual problem here is that the US current account imbalance did not start to increase substantially further from where it was in 1999-2000 until 2004 and by then the dollar had declined by 8 percent from its peak, on a price-adjusted, weighted-average basis. Thus, the adjustment process was working.

Moreover, David makes the almost-standard error of interpretation by identifying official capital inflows to the United States as the marginal inflows, when throughout the period they were an almost-constant 20 percent share of all capital inflows.

In addition, he fails to explain how official inflows, which are largely into shorter-term assets, could have held down long term interest rates or why the Federal Reserve could not have pushed up interest rates earlier and further anyway. He never explores that counterfactual with respect to either part of his argument.

Gian Maria Milesi-Ferretti is in the fourth camp: global imbalances and the crisis were jointly determined by a common force in the form of “financial excesses.” I agree and therefore I have only a few comments.

First, I liked his emphasis on gross capital flows. That is the way to think about these problems and it provides a focus on the advanced countries rather than emerging market and developing countries as where the action is.

However, I do have a few quibbles. Gian Maria makes the same mistake as David Vines with respect to the roll of official purchases of US government bonds. His story about FDI is exaggerated; because FDI is a different type of flow and measured differently, we fail to observe the pressure that foreign direct investors can place on countries in crisis without liquidating their investments. Finally, I found his endorsement of the IMF’s multilateral consultations, which may have been obligatory, not credible. Those consultations had nothing to do with either adjustment or the crisis; they were a sterile exercise.

Manuel Ramos Francia is in the first camp: global imbalances had nothing to do with the crisis. The crisis was caused by lax supervision and regulation that induced a

US consumption glut. However, he fails to identify the problems of supervision and regulation beyond complex products which were not sufficient in themselves to bring down the system. He lets macroeconomic policies completely off the hook, which I think is incorrect as I have indicated. He fails to recognize that the consumption glut in the United States was matched by a consumption dearth elsewhere. The system has to add up. Finally, there is no reason why a large country, such as China, should be allowed to short-circuit the adjustment process (via sterilized intervention in the foreign exchange market) in particular when its previous period of spectacular growth did not require large export surplus.

Thus, these three papers offer three views of the role of global imbalances in the crisis and do not offer much guidance for policy in the future.

Global Imbalances in the Expansion

Depending largely on one's interpretation of the pre-crisis period and the role of imbalances in causing the crisis, one can have three views of whether global imbalances are a problem for the expansion period: (1) global imbalances must not be allowed to reemerge; (2) they are fundamentally benign; or (3) they will take care of themselves as long as macroeconomic policies are appropriate.

David Vines clearly is in the first camp. He spells out a delicate mix of monetary, fiscal, exchange rate, regulatory policies that should be followed to avoid a reemergence of global imbalances. (He actually speaks in terms of reducing imbalances, despite the fact that the US current account deficit is now under 3 percent of GDP and that is where the IMF in April projected it to remain through 2014.) His analysis on this point as well

as the previous point is driven by the view that floating exchange rates are determined by interest rates, which is a convenient assumption that is not grounded in empirical reality.

David also implicitly adopts a two-country view of the world – the United States and China – in which each country needs to rebalance domestic demand and production aided by exchange rate adjustments. Thus, he leaves out both Europe and other emerging market countries. On the former, he asserts that the euro does not need to appreciate despite the fact that there is no a priori reason why the euro should not appreciate or depreciate in his scenario. He does acknowledge potential intra-euro area imbalance issues, which the Europeans generally sweep under the rug. On the other emerging market countries, he is essentially silent about the potential problem of competitive non-appreciation by countries that either are self-insuring or adopting a Chinese growth model.

Finally, his discussion of fiscal policy, in this section, is all in terms of increased taxation despite the fact that over the longer term all the advanced countries face pressures on the expenditure side from aging population and rising health costs.

Gian Maria Milesi-Ferretti is also in the first camp: global imbalances must not be allowed to reemerge. However, he is worried that countries with surpluses and deficits will not adopt optimal policies. His prescription is a rebalancing of growth, but he argues that such a result is not guaranteed. He posits that alternative an excess of desired surpluses will lead (b) to stagnation, (c) to renewed imbalances, or (d) to a US debt crisis.

Both his basic scenario and alternative (b) (stagnation) are plausible, but he has not exhausted the alternatives. The United States could recover via increased investment

and an export boom while the rest of the world does not adjust and therefore stagnates. In other words his arguments are too mechanistically Keynesian.

I should note that the alternative of global stagnation, based upon the WEO forecasts, is a plausible story, but I would like to see some evidence that this residual of surpluses over deficits has been a reliable predictor in the past.

I also do not find his projected trajectories of growth relative to trend plausible in that they show in many cases an increase in the output gap.

Gian Maria's fourth scenario of a US debt crisis and overwhelming foreign exchange pressures strikes me as a retreat that ignores the fact that there has been a lot of exchange rate adjustment over the past seven years.

At the same time he underplays, but does not entirely ignore, the problem of an increased desire for self-insurance and policies of competitive non-appreciation.

As with David's paper there is essentially nothing on Europe or Japan, which I consider a cop out when talking about global adjustment.

Manuel Ramos Francia is in the third camp: imbalances should be allowed to reemerge and will take care of themselves.

The problems I have with this analysis are similar to those I had with the first topic he treats. China is part of the adjustment process along with the United States and the rest of the world. Nominal and real exchange rates are also part of the process. Not all countries can follow export-dominant growth strategies and China does not need to do so.

The bottom line from these papers is that global imbalances are a worry but for different reasons. They may be a threat to global growth, a threat to global stability, or a source of over-reaction. As a result the policy implications are less than clear.

Implications for the International Monetary System

Again, there are three broad views of the implications of the crisis, and the imbalances that preceded it, for the international monetary system: (1) leave it alone, (2) tweak it around the edges, or (3) subject it to a thoroughgoing reform.

David Vines is in the third camp arguing that we currently have a non-system because we have no rules. However, his tough denunciation of the post-Bretton Woods regime is undercut by his rather weak recommendations. They amount to a call for greater consensus about and understanding of the consequences of non-cooperation and a stronger institutional role for the IMF. However, he proposes no new rules or sanctions. In the 1970s, as part discussions of reserve indicators in the Committee of Twenty, sanctions on trade and taxes on excess reserves were on the table.

David is right, however, to see macro-prudential regulation as involving macro-economic policies as well as regulatory policies.

On macro-economic policies, he endorses the use of fundamental equilibrium exchange rates to force countries that peg their exchange rates not to peg, but he does not apply that standard to countries that nominally float their exchange rates.

His proposal to increase the independence of IMF management and staff from the executive board is worth a try, but it is a long shot.

On regulatory policies, David wants to separate investment banking from commercial banking, presumably in Europe and Japan, where they are now combined in universal banks, as well as in the United States. He wants to limit state rescues to commercial banks and naively believes investment banks need no special supervision because their failure cannot have systemic consequences, despite recent evidence to the contrary.

Finally, David endorses an enhanced role for the SDR with issuance possibly primarily to emerging market countries – a proposal that no legislature in an advanced country will endorse.

To my disappointment, David embraces the revived slogan of a US “exorbitant privilege” in issuing the world’s reserve currency. Today many countries issue obligations in their own currencies that are purchased by foreign investors. Over the past decade the euro area has “issued” about \$1.5 trillion in reserves when it was in cumulative current account surplus. The United States came by its privilege naturally and shares that privilege broadly and willingly!

Gian Maria Milesi-Ferretti is in the “tweak the system” camp. He would allow “problems to persist,” which means he wants to see less foreign exchange rate fixity. He wants to increase the international financial architecture via offering better IMF insurance possibly involving the SDR.

The question, as with his treatment of imbalances, is whether his prescriptions are enough. My view is that they are not plausible. We need a better process of problem articulation. We need to declare foreign exchange policy as a growth policy off limits.

We cannot leave Japan and Northern Europe off the hook to be free riders on the rest of the system.

Manuel Ramos Francia comes closest to advocating thoroughgoing reform. He would strengthen the surveillance roles of the IMF and the BIS, reduce the role of the dollar, and improve IMF governance.

However, he offers few details and his previous analysis undercuts his advocacy of the IMF in a role as a stronger umpire or referee. It is not clear to me where Manuel really is on the role of the IMF on the exchange rate policies of members.

Of course, as with David, he makes all the common errors about the dollar's international role. There is no analytical or empirical link between the reserve currency role and current account deficits and the dollar is only two-thirds of global reserves today.

The bottom line from these papers is that we cannot leave the system alone, but there is no agreement on the extent of the needed tweaks, maybe because we lack an agreed diagnosis of the problems.