Global imbalances are here to stay

Remarks by Jean-Pierre Landau- May 2, 2012

The international economic agenda is currently predicated on one major objective: reducing current account imbalances, which are seen as a source of potential financial instability one cause of the crisis, and a threat to future growth.

Tonight I will argue that this emphasis is partially misguided. True, current account imbalances may be dangerous. But they also appear as unavoidable, even a necessary feature of the world we live in . The right policy approach, therefore, is to create conditions where those imbalances can exist and persist without prejudicing growth and financial stability. That calls for a different emphasis and a different set of priorities and policy measures than the ones currently contemplated and discussed in the G7 and G20..

Very little in what I will say is new. A lot is inspired by existing literature, although policy conclusions and prescriptions are mine . So are any errors and mistakes.

The starting point is that we live in a world which is both deeply interconnected and increasingly asymmetric.

That our economies are interconnected is obvious for everyone to see. The absolute synchronization of the recession in 2009-2009 - across all parts of the world - points to a much deeper connection than our traditional models of economic or financial contagion would have implied. More recently, deleveraging by banks in advanced countries, (especially but not only European banks) had its effects felt in financial systems far away in emerging economies.

It is worth looking further into those interconnections. There is obviously a physical component as global production and supply chains are more and more organized on a global scale. Most striking, however, are a financial and what I would call a liquidity component.

Financial interconnections can be best measured by the expansion of gross international asset positions (whereas, of course, the current account only measure evolution in *net* positions). This expansion dwarfs the growth of trade in goods or even GDPs. Taking, as a yardstick, the average between gross international assets and liabilities, it has grown from around 50% of GDP in the US in the 1990s to 150% to day. Some emerging economies, as Singapore, stand at 200% while the Euro area is somewhere in between. Obviously, the composition, the denomination, the maturity of those exposures matter enormously for growth and financial stability. Valuation effects, for instance, have a much bigger impact on net foreign positions than the current account.

There is also what I would call a "liquidity" component. Financial intermediaries form a global network inside which they develop short term claims on each other. Global institutions manage liquidity globally. Shocks in the system are therefore instantly transmitted as those short term exposures can be unwound with no delay. In my view, this the best way to interpret the synchronous recession in 2008-9 : as a global liquidity shock, where both financial and non financial entities across the world started to hoard liquidity in response to the uncertainty created by Lehman's failure.

Let me point to three major asymmetries:

First In savings. There is no need to elaborate much. Saving rates in emerging Asia are double those in advanced economies. Usual explanations evolve around financial repression the absence of social safety net, or even cultural factors. The hard truth is that most saving differences come from the corporate sector, at least over the last decade.

A second asymmetry can be seen in financial development. Again, this is well known. While most EMEs have overcome the "original sin" and can issue debt in their own currencies, many EMES still lack deep and liquid domestic markets. One important consequence, to which I shall return, is an asymmetric ability between countries to produce safe and liquid assets.

Finally, there is an asymmetry in debt situations, both public and private. It has appeared more recently. Public debt will average around 100% of GDP in advanced economies vs 30% in EMES, a stunning reversal from a few decades ago.

Those asymmetries will likely disappear over time. The transition, however, will be long. Stabilizing public debt in advanced economies will prove extremely challenging. And so will financial development in EMEs. Demographic factors may keep pushing up EMEs saving rates.

In the meantime, we will inhabit a world which can be (simplistically) characterized as follows. On one side, there are advanced economies with high absorption capacities but also low savings and high debt. On the other, emerging economies with extremely low debt, high savings and, still, limited absorption capacities. So the main imbalances -those that will count in the next decade- are imbalances *in stock*s. If properly addressed, they can be managed. Advanced countries can manufacture safe assets for savers in emerging economies, and find suitable paths to debt sustainability and growth. And emerging economies may find it convenient to park their wealth in those safe assets in advanced economies. . Which means that international flows of capital and goods flows and current accounts will stay unbalanced. It stands to reason that you don't solve imbalances in stocks by balancing the flows.

It is therefore important to have the right diagnosis and set the right priorities. If we cannot find ways to secure stable and international financial flows, and increase gross international financial exposures, we may return to some kind of financial autarchy, debt problems will be dealt with by each country in isolation, macroeconomic policies in all countries will be more constrained. It's hard to see that the world would be a better place

Does that mean that we should be indifferent, to the current account ? Absolutely not. Large and persistent imbalances can be a source of vulnerabilities; they may be symptoms of underlying domestic imbalances. At the very least, they are indicators of potential troubles and disruptions. Even inside a monetary union, they do matter. One appropriate way to look at the euro crisis would see it as building up of internal imbalances, with extremely fragile financing structures, followed by a sudden stop. To quote Obstfeld, the current account "warrants careful scrutiny with no presumption of innocence."

But it is also true that the level of imbalances that the world can withstand depend on robustness of financial architecture (something we, Europeans should have been aware of). The policy agenda should therefore concentrate on efforts to build a robust architecture, strong enough to support growing financial integration. Achieving that result when global capital markets are still segmented between different sovereign jurisdictions will necessitate efforts in many directions. I will just mention two of them.

First, financial regulation. Most countries would agree that some degree of harmonization is necessary. These are very technical, but extremely important issues, which will decide on the shape of global capital markets for the next decades. Countries will have to choose the right balance between host and home jurisdictions. They will have to agree on how far they can go in implementing macroprudential measures on cross border capital flows. They will have to decide on liquidity regulations. Resolution regimes for global institutions may will shape the future international financial system more than what happens with exchange rates. An important issue is whether current trend towards retrenchment in international banking will persist or simply shows a temporary adjustment of balance sheets.

A second important component of a global architecture relates to the existence of safe stores of values. Every financial system, in fact, any organized society needs a reliable store of value. It serves two main purposes : first to park wealth and transfer it from one period or one generation to another. And, second, it provides self insurance against uncertainty and unexpected shocks.

The demand for such instruments is actually very strong and growing . The supply, on the other hand, is dwindling rapidly. This global liquidity imbalance, to quote Gourinchas, is far more serious than the usual `global imbalance.

Demand for riskless asset comes from the private sector, but also, mainly, from public entities, in particular trough the accumulation of foreign exchange reserves. Following the 1997–98 crisis, emerging countries have constantly sought to expand their foreign exchange reserves. The emerging markets' average reserve ratio has more than quintupled from 4 percent to over 20 percent of GDP since 1990. One cannot assume, however, that equilibrium has been reached and that the demand for reserves will stabilize. On the contrary, there are strong indications that this trend will persist, or even be amplified, following the crisis. Foreign exchange reserves are now used as a tool for *internal* – as well as external – financial stability. National Central Banks, especially in Latin America, acted as dollar lenders of last resort to their domestic banks. This function will develop in the future and is bound to impact the demand for reserves. With no international lender of last resort, precautionary motives could lead to unlimited accumulation of liquidity.

On the other hand, one consequence of the crisis has been to cast doubts on the ability of some assets, up to now considered as riskless, to serve as reliable stores of value. The ability of the private sector to create “safe” assets through financial innovation has proved largely illusory> And one major outcome of the European crisis has been to introduce an element of credit risk in public debt of advanced economies.

May be   can holders of those assets accept some exchange rate risk because it can be diversified away and tend to cancel out on the longer run. There are also ways to get protection : the willingness of many EMEs to contribute toIMF resources may have a lot to do with the advantage of holding claims denominated in their domestic currencies or in SDRs.

But bond holders will have greater difficulty in coping with credit risk. Credit risk makes securities / financial instruments information sensitive, and that, in turn, makes them illiquid in times of stress, precisely when you need them most.

In the future, advanced countries issuing debt instruments may face a kind of “triffin dilemma” as identified by Obstfled and others. Strong issuance will be necessary to satisfy the demand for safe asset. But strong issuance will compromise the creditworthiness of those assets. One major challenge facing the international community will be to find a way to circumvent this dilemma. History, as well as theory, tells us that excess demand for liquidity can be a powerful deflationary force. Coupled with deleveraging in advanced economies could lead to very difficult global environment in next decade.

Credible fiscal consolidation in advanced economies is certainly a prerequisite, but only part of the solution. It would avoid "depreciating" existing debt and further shrinking the pool of available risk free assets. But, by itself, it may not provide a sufficient supply to meet future needs.

There is room for meaningful and positive financial innovation to create new classes of risk free assets. This may be a controversial statement to make right now: one of the causes of the financial crisis may have been misguided financial innovation. This was, however, a disorderly process, poorly supervised and monitored, and whose development was distorted by skewed incentives. A different approach, promoted by public authorities themselves in full transparency would be very different and use financial innovation for the public good.

Many avenues can be explored. Two can be specifically productive:

First, instruments based on real – physical or productive - assets (including land) and replicating partially their risk return profiles. If they don't transfer ownership of those assets, they could help and circumvent the political obstacles attached potentially to a substantial expansion in FDIS from emerging to developed economies.

Second, instruments based on a diversified portfolio of sovereign risk. Most current thinking revolves around the idea of pooling and sharing sovereign risk (through Eurobonds, for example), a step which would create both strong solidarity but impose a high degree of common coordination and discipline on national fiscal policies. Political obstacles, therefore, are enormous and may prevent the emergence of such instruments for a very long period.

The same objective could be achieved, without those political constraints, by seeking safety and liquidity not in the sharing of risk but in the structure of the instrument itself. At the European level, one proposal is to create European Safe Bonds (or"ESBies") obtained by extracting a senior tranche from a diversified portfolio of Government bonds. Properly implemented, and closely managed and supervised, those instruments could provide a much needed supply of safe euro denominated assets (as witnessed by the appetite of non-euro investors for EFSF issuances).

Let me now conclude. By no means do I want to underestimate the benefits of macro economic coordination. It is good. It is necessary. It should be developed and the G20 is doing a very good job at it. Nor would I like to minimize the very significant results achieved over the last four years, when international cooperation has pulled the world economy out of the abyss.

But we are entering a new phase. We have to recognize that interactions between our economies are increasingly determined by the diversity of our structures, preferences and financial systems. That diversity can be a source of tensions and antagonism; or, quite the contrary, it can create mutually beneficial complementarities and increase global welfare. That, in turn, will depend on our ability to build an international architecture, especially an international financial architecture commensurate with the level of interdependence we have achieved.