Global imbalances: the perspective of the Banco de México

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Global imbalances (GIs) have been with us for quite some time. To a large extent, for many years they were disregarded by the world economic powers. Such imbalances provided fertile ground for a major financial crisis to erupt. Regretfully, many of the policy measures implemented as a response to the crisis have exacerbated the damaging potential of GIs. The most recent manifestation of this is the rapid expansion of beggar-thy-neighbour policies that an uncoordinated policy response to GIs is leading to. Under this scenario, G20 policymakers should be alert and devote their efforts to search for possible agreed upon solutions to the underlying disequilibria; otherwise, we could be sowing the seeds for a new, potentially more devastating crisis.

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Global imbalances (GIs) are a very complex phenomenon resulting from the interaction of multiple factors. Globalisation of capital markets, a never-before-seen increase in consumption in the world's largest economy, and the emergence of the most populated country as an economic power with the ability to produce vast amounts of goods at very low costs are some of the main elements that allowed for the existence of such imbalances. GIs started more than a decade ago with the persistent current account deficit in the United States and the consequent surplus in a number of countries, among which China stands out. Previously, the major concern resulting from this situation was the possibility of a rapid and disorderly reversal of the imbalances that could engulf the world in a crisis. Nowadays, the main preoccupation stems from the effects of the possible expansion of beggar-thy-neighbour policies to which the necessary correction of GIs is leading, in the context of a fully blown financial crisis, which is still in the process of being resolved.

A question put forth frequently has been the extent to which GIs contributed to such a crisis. While there is no consensus on the role of GIs as a trigger of the financial crisis, there seems to be some agreement regarding the existence of a profound interrelation between the two.

Before the crisis, the inexpensive and abundant flow of resources available in the US financial system, characteristic of GIs, contributed to setting up the conditions necessary for the turmoil to erupt. These resources were allocated to the different sectors of the American economy, among them housing. The magnitude of such capital inflows, combined with the now well-known handicaps in the regulation and supervision of financial institutions, fueled a huge housing prices increase, which evolved into a "bubble". This, together with an extremely active mortgage market, produced a large increase in the perceived wealth of the US population.

The resulting housing price "bubble" in the United States led to an increase in consumption above the levels consistent with permanent income. *Ex ante* this situation was not worrisome as the increase in wealth was perceived to be permanent. However, *ex post* it became clear that the housing price increase was only temporary. Therefore, the higher consumption levels that US society got used to became unsustainable, as many households were left with large debts to repay without really having the capacity to do so. This is the current scenario for the United States, a situation in which a reduction in consumption levels and patterns seems to be unavoidable; however, the way in which this adjustment will take place is uncertain due to its magnitude, the instruments available to harness it, and the political complications surrounding the issue.

A main element of the recent crisis is that it was global and shattered the stability of the entire financial system, producing panic among investors. At the height of the crisis in late 2008 and early 2009, capital flowed to the United States as a result of paradoxical "flight to safety" considerations; paradoxical because as a result of such considerations resources flowed to a country with a banking crisis, an expansionary fiscal policy, a lax monetary stance and large current account and fiscal deficits. It is difficult to envisage capital flowing into a country with such characteristics, but it did in the case of the United States, given its institutional strength, its wealth, and the perception that the US Government had sufficient degrees of freedom to deal with the circumstances(as it has done so far). But these phenomena precluded a substantial real depreciation of the dollar, which would have eased the transition costs out of the crisis and would have contributed to alleviate the pressures coming from the GIs, as a matter of fact accelerating their correction. In this sense, the token capital flows switched off one of the main adjustment mechanisms to the GIs. In effect, historically it has been precisely an abrupt adjustment in the exchange rate which has been the main correction mechanism in those episodes where countries have accumulated unsustainable deficits in the height of fiscal imbalances, monetary expansion, and a fully fledged banking collapse.

After the eruption of the crisis, GIs levels were significantly reduced, but this seems to have been mostly a short-term response, given that trends are already returning to what they were before. This fact emphasises the importance of closely monitoring and studying current account balances and other aggregates to assess the measures that need to be taken to reduce the possible risks associated with them.

With respect to the parties on the other side of the imbalance, the three largest economies after the United States (i.e. China, Germany and Japan) have had persistent current account surpluses for some time. However, China presents the most interesting case due to the international perception regarding the management of its currency derived from its growth strategy. Given this, it is reasonable to focus the discussion on China and the United States, although we ought to keep in mind that China is not alone as a counterpart to the huge US current account deficit.

All in all, and even if it might sound surprising, the fundamentals of the Chinese economy are supportive of a relatively depreciated real exchange rate. In particular, high precautionary savings related to the lack of social safety nets, a foreign reserve strategy based on acquiring US Treasury securities influenced by the underdevelopment of the Chinese financial system, and a very abundant and elastic labor supply – with the consequent low real wages – resulting from migration patterns from rural areas to production centers, all contribute to the compression of absorption, and therefore, to a relatively depreciated real exchange rate.

Under these circumstances, the way to address GIs is by fostering structural reforms aimed at reducing the underlying deficiencies of countries like China that limit exchange rate flexibility. The creation of social safety nets and the development of its financial system could reduce Chinese savings levels and the dependency on US Treasury securities as the principal source of risk-free assets. Along the same lines, China could also allow for the flow of reserve money to sectors that have been closed and are underdeveloped, easing the direct downward pressure on the exchange rate and creating the real sources of development without the need of a constantly undervalued real exchange rate.

As a matter of fact, the need for more exchange rate flexibility among G20 economies stems from the conviction that it would lead to a less costly adjustment of GIs in terms of global growth and financial volatility. The necessary consumption adjustment in the United States due to households' deleveraging process and the complicated situation in its labor market imply possible deflationary risks. However, a deflationary process in an economy with high leverage levels would only compound the problem. This complex situation makes understandable the implementation of an extraordinarily accommodative monetary policy by the US Federal Reserve. Regretfully, this is nevertheless producing unintended consequences worldwide. Precisely because of this, more exchange rate flexibility in some Asian economies, and in China in particular, is urgently needed, since it would lead to a situation where the degree for monetary accommodation in advanced economies would be reduced.

In the recent past, investment in emerging market economies has become more attractive for several reasons. Among these are the higher rates of growth in such countries, the fact that they are coming out of the crisis without any significant structural damage, and also that they have more degrees of freedom regarding the potential implementation of policies geared towards stimulating growth. However, this relative attractiveness of emerging economies has been compounded by the aggressive monetary expansion in the United States. As a result, there has been a massive increase in the flow of resources to these countries. This by itself could be a good sign. However, the speed and amounts at which capital is inflowing can represent destabilising forces, and have generated concern among some export-driven economies whose currencies are appreciating in real terms to the detriment of their export sectors. In this context, it is important to differentiate among those countries whose currencies have been appreciating due to underlying structural phenomena and those that are suffering mainly due to the abnormally lax monetary policy stance in advanced economies, mainly in the United States.

Increased capital flows can be a powerful force towards development; however, to get the most out of them it is necessary to differentiate between those capital flows that arrive in search of long-term projects and those short-term resources that simply are attracted due to lax monetary conditions elsewhere. In this sense, it is important for emerging economies to generate incentives to drive flows towards productive long-term projects, and reduce incentives for flows that could result in an unwarranted increase in domestic consumption. To do this, it is necessary for those countries to open up and allow investment flows into sectors that are presently restricted, so as to reap the full potential of the increased capital flows.

Some countries are using the potential negative externalities produced by rapid and massive capital inflows to justify the introduction of taxes and other controls applicable on them, as well as interventionist exchange rates policies. Such reactions, in combination with the lax monetary policies in the advanced economies, threaten the long-term financial stability and growth of the world economy by placing it on the verge of a currency-trade predicament in which no one wins. This is the case because while the policies used are implemented to solve short-term issues, they impose long-term distortions on the economy, hurting activity. Additionally, the efficacy of these policies is limited due to the increasingly global nature of capital markets. The trend towards restrictions on capital flows, trade barriers, and even "currency wars" reminds us of a protectionist era that we have fought hard to put behind us.

It is important to highlight the fact that those countries that resist joining these practices are more likely to incur short-run costs, although they are also more likely to receive future benefits derived from stable capital flows and the avoidance of introducing major distortions to their economies. In this sense, policymakers are faced with a short-term versus long-term conundrum in which making decisions is not simple. A close look at past experiences has shown that focusing on the long run has been more fruitful; nevertheless, circumstances might force the broad adoption of undesired policy actions if the pressures become overwhelming. Let us just hope that if these measures are applied, they are done so in the least harmful way possible.

All in all then, I believe that it is urgent for the world to move to a scenario with higher policy coordination among countries. Of course this means paying more than lip service to shared responsibilities. On the one hand, surplus countries should put in place structural policies conducive to more appreciated *equilibrium* real exchange rates. On the other hand, deficit countries should implement policies that are consistent with more depreciated *equilibrium* real exchange rates, that is, policies that recognise that domestic absorption needs to be at levels that are sustainable and not policies that could have very adverse externalities for most countries and that in the end will probably only postpone the adjustments that need to take place anyway.

At the international level, this policy discussion can be compared with a regular prisoner's dilemma. While staying put achieves a more efficient outcome, incentives are such that individual movements are desirable for each player but together can imply collective ruin. In this sense, policymakers in the G20 countries must place enough emphasis on the repeated nature of the game pursuing the more efficient equilibrium by inducing countries to cooperate.

Wrapping up, it could be asserted that GIs generated fertile ground for the financial crisis to erupt. When it materialised, it destabilised the global financial sector, which in turn has had significant effects on the growth prospects of the main advanced economies. Furthermore, sluggish growth rates observed after the turmoil generated incentives for policymakers to try to induce growth through a broad range of expansionary policies. A scenario in which GIs are not corrected can make matters worse for the global economy. Some sources of concern along these lines are the fact that some developed countries have larger and increasing public debt derived from onerous stimulus packages and bailout costs, and that policies are increasingly distorting capital flows and monetary conditions with the intention (sometimes veiled) of getting an edge on other countries. Under this scenario, policymakers should be alert and searching for creative solutions to these new conditions; otherwise, we could be sowing the seeds for a new, potentially more harmful and devastating crisis.