



# Global imbalances and the crisis

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**Richard Portes**

London Business School and CEPR

*Growth Commission*

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# Road map

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- Global imbalances (GI) caused crisis
- GI *interacted with* greed, incentive problems, financial innovation, weak regulation
- Concerns going forward: SR v. LR
- Policies: markets, imbalances, institutions
  - focus on regulatory reform misses GI
  - must develop domestic financial markets of emerging market (EM) countries
  - *provide credible insurance against sudden stops*
  - improve global governance: G20, IMF, FSF

See Dewatripont, Freixas and Portes, *Macroeconomic Stability and Financial Regulation: Issues for the G20*, CEPR, 2009



# GI: the issues

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- Increased *dispersion* of CA over the past decade – counterparts are much bigger net and gross capital flows, *putting pressure on intermediation*
- Capital flowing the ‘wrong way’ – from poor and EM countries to AC
- *Not* just a US-China story: UK, Spain, Australia with large CA deficits; Germany, Japan, several Asian EM and commodity exporters with large CA surpluses
- And loose monetary policies together with reserve accumulation brought excessive global liquidity



# The problems

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- *Not* (yet) the feared unravelling of imbalances, 'sudden stop' for US, abrupt dollar depreciation
- But GI played significant role in fall of volatilities from 2004 to mid-2007
- Low volatilities, with low interest rates and low inflation, led to 'search for yield' and increase in leverage
- Search for yield created demand for financial 'innovation'



# GI were not and are not a sustainable equilibrium

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- 'Bretton Woods II' misunderstood rationale for trade surpluses – in fact, EM countries built up precautionary reserves to deal with 'sudden stops'. Also too focused on China, put excessive emphasis on exchange-rate policy.
- 'Global asset shortage' – excess savings countries with undeveloped domestic financial markets forced to buy US securities. But (i) surplus country savings went into *all* AC financial assets, with wide range of quality (ii) gross flows to US didn't come primarily from private sector
- And both stories *ignore stresses on financial intermediation* and are *asymmetrical* (as is 'savings glut' version).



# Concerns looking forward

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- AC fiscal stimulus programmes will generate large increase in net debt issuance – who will buy it, with what effects on interest rates, prices, and exchange rates?
- Fears of inflation, ‘crowding out’ EM from capital markets, EM defaults
- Can RoW do without US deficits? Must have rise in domestic demand in *surplus* countries, which requires they *accept fall, perhaps reversal of their CA surpluses*. This is *not* primarily an exchange rate issue.
- Will there be a dollar crisis after all?



# Policies: objectives

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- Limit *both* GI and financial fragility
- Avoid reversing financial development and financial integration
- Avoid financial repression
- Get capital flowing from AC to EM and poor countries



## Policies: the markets

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- Limit borrowing and leverage of financial institutions – implications for GI
- Control currency mismatches
- Develop EM domestic (local currency) securities markets



# Policies: dealing with GI

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- *Credible insurance* to countries that forego further reserve accumulation
- more central bank swap lines
- 'reserve pooling'
- expand IMF resources, use flexible, fast-disbursing schemes with low conditionality – FCL the right instrument, Mexico and Poland showing the way
- Reduce focus on exchange rate adjustment



# Policies: the institutions

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- IMF needs legitimacy – major quota redistribution
- Either IMFC should run IMF or Executive Board structure and role must change
- But will EU, and in particular the UK, be willing to play?
- FSB should expand secretariat, take on capital markets functions from IMF
- G20 the right forum to avoid free riding
- Can't fix system without fundamental agreement to reduce GI – a 'deal' between reserve-accumulating countries and those running deficits