System Malfunction

The global economy is rife with imbalances that cannot be fixed under the present international monetary (non)system

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THE global economy today is characterized by various kinds of international imbalances, any of which could cause a future crisis. It seems worth asking whether these various imbalances have a single root—the absence of an international monetary system. It is a simple fact that we no longer have internationally agreed rules of behavior to constrain the shorter-term actions of individual sovereign states with a view to longer-term benefits for all.

There were such rules under the gold standard that preceded World War I and under the Bretton Woods system that followed World War II but imploded four decades ago. There are such rules today in the euro area. But at the global level there are none. Major countries can, and generally do, pursue their own short-term interests, not least through lower interest rates and other unconventional monetary policies to stimulate the domestic economy regardless of the implications for other countries. This runs the longer-term risk of unexpected consequences at home, not least the possibility of future inflation and other domestic imbalances. Moreover, by creating international imbalances of various kinds, such policies may also act against the longer-term best interests of other countries.

Who is concerned with the good health of the global economy as a whole? Since the demise of the Bretton Woods system, the IMF—which oversaw the system—has been concerned primarily with monitoring the behavior of its member countries and providing conditional assistance to countries in need. Nevertheless, the IMF has continued to express concern through various channels about national policies it does not deem in the best interests of the global community. However, for many large countries, these policy recommendations count for little more than advice. The United States, although the world's largest international debtor, has freedom of action thanks to the continued use of the dollar as the principal reserve currency. As for large creditor countries, the IMF's influence over their policies has always been very limited.

Global imbalances

When economists talk of global imbalances, they may be referring to a number of different concerns. The most long-standing source of concern is *current account* imbalances—the difference between what a country spends abroad and what it receives from foreign sources. The current account measures net imports and exports of goods and services, income (such as salaries and dividends), and transfers (such as remittances and pensions). By definition current account surpluses and deficits are equal to *net capital flows*. The risk is that countries with large current account deficits can lose the confidence of those who are the source of such flows, which can culminate in a foreign exchange rate crisis. Such crises commonly hurt both output and employment. Ironically, despite repeated warnings about this possibility for the United States, which has run regular current account deficits since the 1960s, no crisis has materialized. In contrast, major increases in current account imbalances among countries in the euro area did eventually lead to crisis, shattering the belief that such crises were impossible inside a single-currency zone.

A second kind of global imbalance, related to *gross cross-border capital flows*, has received increasing attention in recent years. For all its presumed merits, *hot money*, funds that flow from one country to another from investors seeking the highest returns, can wreak havoc on smaller countries—both on the way in and on the way out. Indeed, as became clear in the southeast Asian crisis of the late 1990s, problems with currency mismatches—in which assets are denominated in domestic currency and liabilities, such as loans, are in a foreign currency—can destroy whole banking systems. Borrowers earn income in the domestic currency, and when it depreciates, loans denominated in foreign currency are more expensive to repay. Moreover, the source countries of these flows can in turn be severely affected as well. In a nutshell, if the debtors (who borrow in the foreign currency) cannot pay, the creditors do not get paid.

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Finally, the term global imbalances could evoke concern about the *observation at a global level of domestic imbalances* previously seen only in a few advanced market economies, like the United States. How might these domestic imbalances have spread out from those few large countries? When large advanced market economies eased their monetary policies to support domestic growth, it put upward pressure on the currencies of smaller advanced economies (such as Switzerland) as well as on those of most emerging market economies. For various reasons, the governments and central banks of these countries responded by also easing monetary policy, thus encouraging lending and debt accumulation. As a result, the level of nonfinancial debt in the Group of 20 advanced and emerging market economies (G20) rose from 210 percent of GDP in 2007 to 235 percent by late 2014. Moreover, most of the expansion occurred in emerging market economies. Whereas in 2008–09 those countries were considered part of the solution to the global financial crisis, they now seem part of the global problem.

A deficient nonsystem

The various deficiencies in the current international (non) system essentially map the definitions of imbalances described above. Crises will replay until we remedy all the deficiencies described below.

First, *there is no automatic international adjustment mechanism.* In principle, countries with large external debt and/or

current account deficits should, in a freely floating exchange market, face downward pressure on their currencies. The weaker currency would make their exports cheaper, which should encourage a shift in production to satisfy foreign demand. Policy measures should then be used to reduce domestic demand to allow production to shift to satisfy export demand. The opposite set of forces should occur in large-surplus countries. This sequence of events allows orderly adjustment, preempting the buildup of still larger imbalances in both surplus and deficit countries and averting a crisis.

But in practice, these forces often operate only over very long time periods. It is an illusion to think that reliance on free-floating rates will painlessly resolve current account imbalances:

- Exchange rate movements seem to have little to do with longer-term debtor and creditor relationships. Driven by short-term momentum trading, in which traders buy and sell currencies to cash in on what they anticipate will be a continuation of increases or decreases in their value, exchange rates can deviate for years from levels consistent with underlying fundamentals.
- Exchange rate changes do not always, or at least not quickly, induce the desired shift in production capacity. Consider, for example, the recent depreciations of the Japanese yen and the British pound sterling, which have not led to the desired increase in the volume of exports.
- Domestic policies need not reflect a country's external position in any way. The United States is the world's biggest international net debtor, yet there is nothing to impede it from responding to periods of weaker overall demand with still more policies to stimulate domestic demand. Similarly, Japan, China, and Germany are huge creditors, yet there is nothing to discourage them from responding to weaker overall demand with efforts to expand exports even further. From a longer-term perspective, recent efforts to encourage a lower euro and yen have not been helpful and could even induce similar behavior by China.

Second, *spillovers from the monetary policies of large advanced economies are disruptive.* With low rates in the United States and many international loans denominated in dollars, longer-term rates in other countries are increasingly correlated with U.S. rates. As a result, a direct stimulative effect on spending in other countries affects the prices of currently produced goods and services as well as of assets. Some academic observers suggest that the only way these countries can restore a modicum of autonomy in setting monetary policy is through capital controls—which place restrictions of various sorts and intensity on inflows and outflows of capital.

Moreover, monetary stimulus seems to reduce perceptions of risk by investors. Before the global financial crisis this led banks with global reach to increase their lending faster than their capital (that is, increase leverage) and to boost lending to smaller countries. Since the crisis, the Bank for International Settlements has observed that international capital flows have been increasingly dominated by asset management firms that buy bonds issued by corporations in emerging markets. A large proportion of these bonds (especially in Latin America and southeast Asia) are issued in offshore financial centers and are denominated in dollars. This raises again the specter of currency mismatch problems if the dollar continues to strengthen. Moreover,

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these capital inflows, together with policies designed to hold down the exchange rate, threaten both inflation and other imbalances related to very rapid credit expansion in emerging market economies.

Those who believe that spillovers from advanced to emerging market economies can be significant propose a number of ways for affected countries to protect themselves. Essentially these suggestions come down to trying to cut each of the links in the transmission mechanism just described:

- Use regulatory means to reduce the use of leverage by banks with global reach, and use regulatory means to control the outflows of capital by large asset management firms.
- Let the exchange rate rise more.
- Employ capital controls to regulate inflows.
- Mitigate the implications of such inflows through the use of macroprudential policies—regulatory policies directed toward reducing the risk of a failure of the financial system as a whole rather than traditional policies, which are aimed at individual institutions.

In recent years, the IMF has actually endorsed many of these suggestions—not least the use of capital controls and more vigorous macroprudential policies. These approaches might help buffer spillovers, though each has downsides as well. For example, regulations, capital controls, and macroprudential measures are all porous; that is, they can be evaded and involve significant distortions in free markets. They also lose their effectiveness over time. Although it may seem sensible to allow the exchange rate to take more of the burden of adjustment, momentum trading can drive freely floating rates far from their underlying parity for long periods, with associated economic distortions. In short, there is no magic bullet.

Third, *the current "nonsystem" is fundamentally unanchored.* Construction of a global Taylor rule (devised by economist John Taylor to determine how much a central bank should change interest rates to respond to inflation pressure) shows that the global policy rate between 2002 and 2012 was in fact systematically lower than the level prescribed by the rule. Other approaches show that beginning in 1997 global measures of the financial real (after inflation) rate fell below similar measures of the longer-term natural rate (the rate that would keep inflation low and economies producing at their potential, as estimated by the IMF). Moreover, the differences between the financial (real) and the natural rate then widened significantly in the years leading up to the global financial crisis. Since the beginning of the crisis, central bank measures have restored a modicum of financial stability but have also increased the size of central bank balance sheets to unprecedented levels. How this will play out over time remains to be seen.

Today, monetary policy continues to be aggressively expansionary almost everywhere. This is particularly important for the United States, which remains the anchor of any vestige of an international monetary system. However, the central bank, the Federal Reserve (Fed), must set its policies solely on the basis of the expected implications for the United States. This is unfortunate not only for countries affected by the spillovers but could hurt the United States as well. Countries outside the United States now account for a much larger share of output than, say, 20 years ago, and problems elsewhere could easily feed back to the United States in unexpected ways.

There is now a burgeoning amount of literature on measuring global liquidity—the amount of credit and funds sloshing around the world. This is certainly a welcome development in that we need to keep track of monetary and credit growth in the world as a whole. But there is no control mechanism to moderate or accelerate the growth of global liquidity that appears either excessive or inadequate. Some have suggested an internationally coordinated monitoring process to assess the effects of national monetary policies on others. However, an assessment is also needed to determine whether a rule-based international monetary system might not be better still.

Fourth, *there are no adequate sources of international liquidity should crises occur.* The IMF's available resources to support countries with balance of payments difficulties would be totally inadequate if a number of small countries got into trouble simultaneously—or even just one big one. Without adequate public sector financing, a withdrawal of private sector financing would cause domestic demand to decline so much that the current account deficit would effectively disappear. But the resulting recession would be extraordinarily painful—as demonstrated in Indonesia in the late 1990s, when the loss of private financing led to collapse in the economy and massive inflation. The more recent deep recessions in some countries in the European periphery, after international banks (mainly in core European countries) pulled back their lending, are a further testament to such problems.

It is true that, in the early days of the 2008 global financial crisis, the Fed opened so-called swap lines, which made dollars available to a number of countries. Many European banks, for example, suffered a loss of dollar liquidity when funding sources in the United States (especially money market mutual funds) essentially dried up. Nevertheless, a limited number of countries benefited, and the criteria for choosing them were opaque and set by the Fed rather than by the international community. In addition, the swap lines were to be temporary, but were made permanent in October 2013.

If countries feel that they cannot rely on the IMF for adequate liquidity support during crises—or wish to avoid the conditions associated with IMF-supported programs—it is not surprising that they seek to self-insure by accumulating reserves. Unfortunately, reserve accumulation helps keep the value of appreciating currencies down, which increases the likelihood of rising inflation, other imbalances, and a subsequent crisis. Such a crisis seems to be threatening in a number of large emerging markets today. To put this another way, reserve accumulation increases a country's capacity to deal with a crisis but also makes such a crisis more likely. Moreover, countries are tempted to resort to regional exercises of mutual support, such as guaranteed lines of credit from other central banks in the region. Although useful in some respects, these regional arrangements can also erode the sense of global solidarity. They can also lead to significantly less conditionality—changes in economic regulatory policies, for example—than the IMF would ordinarily require in exchange for its support. More moral hazard, in a world awash in moral hazard, hardly seems an optimal global outcome.

Rules needed

What passes for an international monetary system today is not really a system because it has no rules. It lacks an automatic international adjustment mechanism for current account imbalances. It allows massive spillovers, including gross capital flows, from larger countries (especially the United States) to smaller ones with potentially damaging implications. It is dangerously unanchored with respect to global credit and monetary expansion, and it lacks an international lender of last resort with adequate resources.

Voluntary agreement by all large countries to an international monetary system that imposes responsibilities on everyone could play a significant role in reducing the dangers associated with global imbalances. Debtors would effectively import the will to do speedily what needed to be done. Creditors too would be forced to play a role, consistent with the recognition that crises also rebound on them. Getting all actors to recognize the shortcomings of the current nonsystem would be a welcome if difficult first step. However, mobilizing the will of sovereign nations to cooperate to devise a global system that would be in their own longer-term interest will be even more challenging. ■

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