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Global Imbalances and Financial Stability

Miranda Xafa

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Abstract

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This paper discusses two opposing views on global imbalances: The "traditional view", which regards the imbalances as a threat to global economic and financial stability, and the "new paradigm" view, which considers that they are the natural consequence of economic and financial globalization. In terms of their policy implications, the traditional view focuses on monetary and fiscal policy decisions in the United States that need to be urgently reversed to avoid an abrupt unwinding of the imbalances involving a sell-off of dollar assets, a sharp increase in U.S. interest rates, and a hard landing for the global economy. By contrast, the new paradigm view considers that the imbalances will be resolved smoothly through the normal functioning of markets. The paper argues that an abrupt unwinding of imbalances is highly unlikely and advances a number of arguments in support of the new paradigm view.

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¹ Miranda Xafa is a member of the International Monetary Fund's Executive Board. The views expressed are strictly personal.

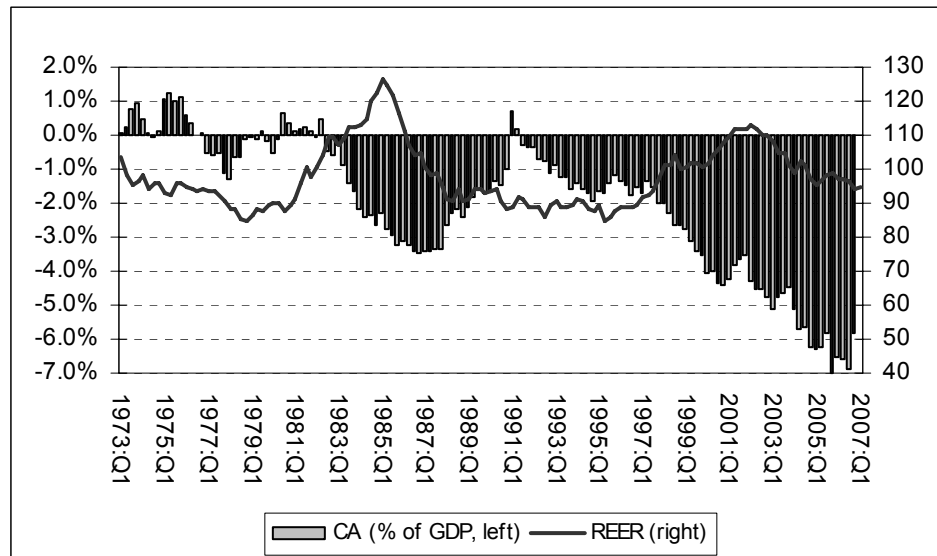
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I. Introduction

The U.S. current account deficit has grown steadily since the early 1990s to the historically unprecedented level of \$857 billion (6.5 percent of GDP) in 2006 (Figure 1). Much attention has focused on the causes and sustainability of the “global imbalances” – a euphemism for the large U.S. deficit – and on the appropriate policy response. Observers are divided in two camps: those who think that this is a dangerous situation which poses serious risks for global economic and financial stability (Cline (2005), Obstfeld and Rogoff (2000, 2004), Roubini and Setser (2004)), and those who believe it is a natural by-product of real and financial globalization (Caballero et al. (2006), Cooper (2005), Dooley et al. (2003, 2004), Gave et al. (2005)). At the risk of oversimplifying, in what follows I refer to the first view as “the traditional view” and to the second as “the new paradigm” view. The traditional view regards the imbalances as a temporary aberration that needs to be urgently addressed through policy action, while the new paradigm view considers that they are the result of structural changes in the global economy whose impact will be felt for years or even decades.

FIGURE 1. CURRENT ACCOUNT DEFICIT AND
REAL EFFECTIVE EXCHANGE RATE OF THE DOLLAR
(March 1973 = 100)

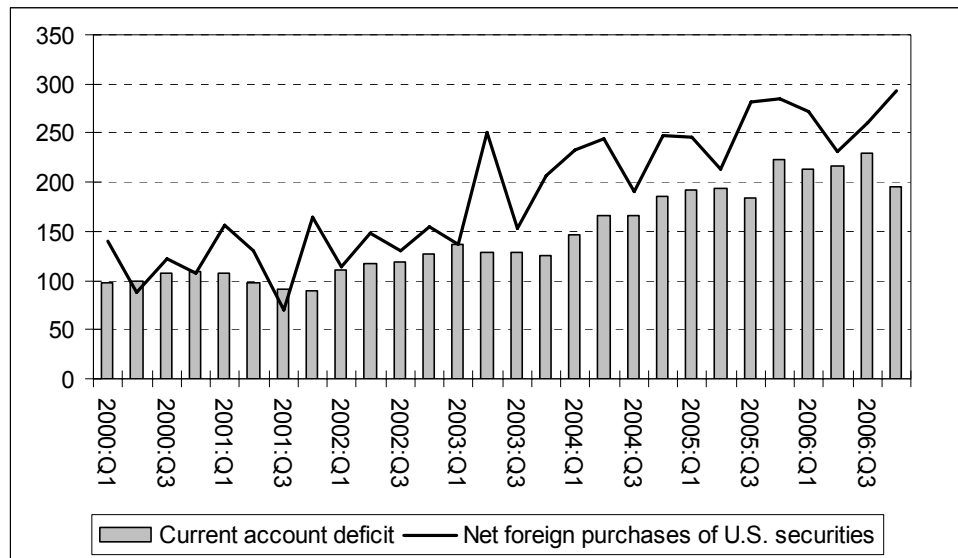


SOURCES: Federal Reserve Board and Bureau of Economic Analysis.

The traditional view focuses on the decline in the U.S. national saving rate since the beginning of this decade, reflecting the swing from fiscal surplus to deficit and the decline in household savings – the result of asset bubbles in the equity and housing markets. In this view, the widening of the U.S. current account deficit is the result of fiscal and monetary policy decisions in the United States that need to be urgently reversed to avoid a possible loss of market confidence. A “sudden stop” of capital flows to the United States would trigger an adjustment process involving a massive sell-off of dollar assets, a sharp increase in

U.S. interest rates, and a “hard landing” of the U.S. and global economy. To avoid the possibility of such an abrupt unwinding of imbalances, policymakers have called for joint action to rebalance demand across regions, with the United States reducing its fiscal deficit, the European Union implementing growth-enhancing structural reforms, and Asian countries boosting domestic demand and letting their currencies appreciate (IMFC Communiqué, September 17, 2006). Multilateral consultations involving the main players (U.S., EU, Japan, China and Saudi Arabia), launched by the IMF in the spring of 2006, were aimed at discussing the policies needed to rebalance demand while maintaining robust global growth. These consultations resulted in a joint communiqué in April 2007² spelling out the policy commitments of the countries/regions involved. Market reaction to the joint communiqué was muted, presumably because the announced policy commitments represented “old news”.

FIGURE 2. U.S. CURRENT ACCOUNT DEFICIT AND NET FOREIGN PURCHASES OF U.S. SECURITIES (\$ BILLION)



SOURCES: U.S. Treasury TIC data and Bureau of Economic Analysis.

Far from being deterred by the absence of joint policy action during 2000-06, foreign investors displayed an ever-growing appetite for U.S. securities (Figure 2). By 2006, net foreign purchases of U.S. securities had reached \$1,142 billion, of which \$956 billion were from private investors and only \$185 billion from official sources³. Subtracting net U.S. purchases of foreign securities of \$249 billion, the net inflow of \$893 billion still exceeded the record-high current account deficit of \$857 billion.

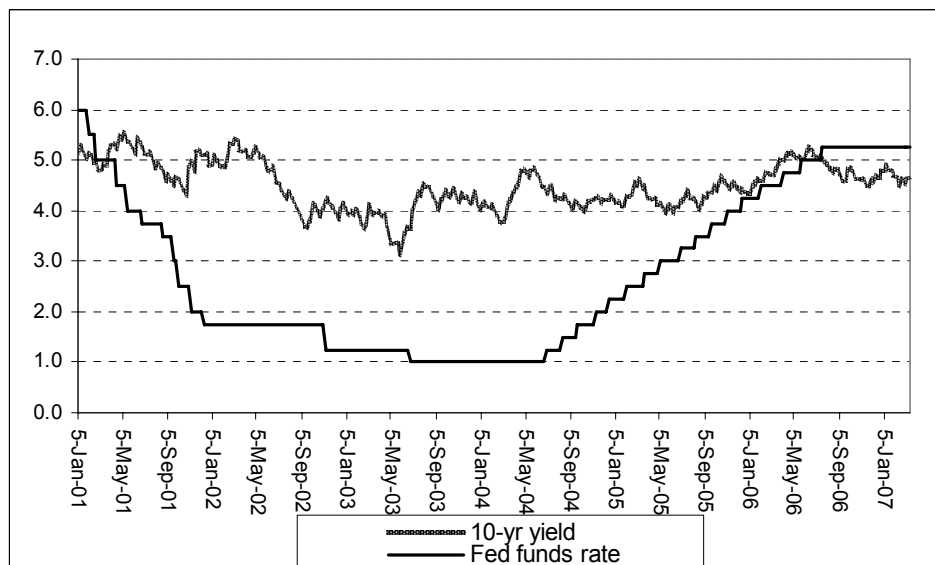
² IMF Press Release 07/72, April 14, 2007.

³ The U.S. Treasury International Capital data (TIC) record transactions based on the location of the transactor rather than the ultimate investor, and may therefore underestimate official transactions booked through brokers in financial centers.

A puzzling aspect of the imbalances is that the counterpart of the growing U.S. current account deficit is no longer surpluses mainly in Germany and Japan, as was the case a decade ago, but also in the emerging market countries as a group, whose external position shifted from a deficit of \$74 billion in 1996 to a surplus estimated at \$587 billion in 2006 (or from a \$63 billion deficit to \$305 billion surplus excluding the oil-producing Middle East). The shift of emerging market countries to a surplus position goes against the textbook view that they should be capital importers.

Another puzzling fact surrounding the imbalances is that global long-term interest rates, both nominal and real, are well below their historical norms at this stage of the business cycle, and they have hardly risen following the tightening of U.S. and global liquidity conditions since mid-2004 (Figure 3). This fact, known as “Greenspan’s conundrum”, has helped limit the cost of servicing U.S. external debt.

FIGURE 3. U.S. 10-YEAR TREASURY YIELD AND FED FUNDS RATE (%)



SOURCES: Federal Reserve Board and Bloomberg.

II. Low U.S. savings versus other factors

The “low U.S. savings” view is not convincing for a number of reasons. First, it is incompatible with the observed low nominal and real interest rates at this stage of the cycle, after considerable tightening by major central banks. Second, it cannot explain the fact that the U.S. current account deficit started rising during the 1990s – a period during which the U.S. fiscal deficit declined sharply and swung into surplus. Third, there are reasons to believe that U.S. savings are understated. Cooper (2005) notes that U.S. national accounts (NIA) data underestimate savings by excluding purchases of consumer durables and expenditure on education and R&D from the definition of savings. Taken together, these categories

amounted to 19 percent of GDP in recent years. I would add that NIA data also exclude capital gains (e.g. on housing and financial investments) from the definition of savings, although they, too, potentially raise future consumption. At a minimum, low U.S. savings alone cannot explain the imbalances.

Other theories, focusing on developments outside the United States or previously neglected benign factors, take a more sanguine view. These theories, reviewed in an earlier paper (Xafa, 2007) and briefly summarized below, have important implications for the sustainability of the U.S. external deficit. Together with the “portfolio balance” models and “asset shortages” discussed below, they should be viewed as complementary to, rather than competing with, the “new paradigm” view.

(a) The “*Global Savings Glut*” view, first advanced by Bernanke (2005), points to a combination of factors that have encouraged savings outside of the United States. These include the aging of populations in Europe and Asia and the associated need for precautionary savings, a lack of investment opportunities in Asia as it recovers from the 1997–98 crisis, and the rise in oil prices and related rise in the current account surpluses of oil exporters. According to this view, we just have to be patient until the factors that attracted global savings to the United States unwind.

(b) The “*Revived Bretton Woods*” view (Dooley et al. (2003, 2004) explains the paradox of savings flowing from developing countries to the United States, as well as the low global interest rates, through the export-led strategy pursued by Asian countries. This strategy requires keeping the exchange rate undervalued by resisting appreciation in order to channel domestic and foreign direct investment to the export industries. The result is persistent current account surpluses and reserve accumulation by Asian central banks, thus generating Bernanke’s global savings glut and keeping interest rates low.⁴ In this view, Asian countries with underdeveloped financial systems are better off exporting their savings to the United States by buying U.S. bonds, and re-importing some of these savings in the form of FDI. The accumulation of dollar assets by Asian central banks is effectively used as collateral for FDI. Contrary to conventional wisdom, this development strategy has permitted developing countries that are net *lenders* to grow rapidly by ensuring efficient intermediation of their savings and thus acquiring a world-class capital stock. The policy conclusion is the same as Bernanke’s: benign neglect.

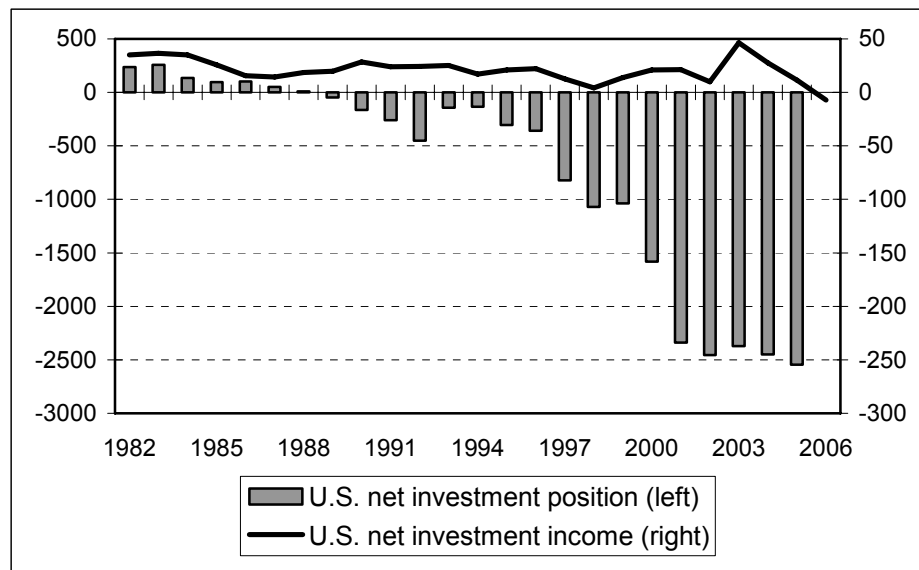
(c) “*Exorbitant Privilege*”: Gourinchas and Rey (2006) note that the United States earns a higher return on its foreign assets (consisting mainly of equities and FDI) than it pays on its liabilities (mainly bank deposits and bonds). This fact explains why the U.S. investment

⁴ In effect, the global propensity to save has not increased; what has increased is the share of global savings invested in international versus local markets, i.e. “home bias” has declined.

income balance remained positive until 2006, even though the U.S. net international investment position turned strongly negative since the mid-1990s (Figure 4).⁵

This “exorbitant privilege” (a term first used by President DeGaulle) reflects the unique role of the United States as the reserve currency country and “banker of the world,” offering liquid, low-risk low-return assets while buying higher-yielding assets from the rest of the world. Moreover, dollar depreciation, *ceteris paribus*, improves the U.S. net international investment position because it raises the dollar value of assets (denominated in foreign currencies) while leaving liabilities (denominated in U.S. dollars) unaffected. Gourinchas

FIGURE 4. U.S. INTERNATIONAL POSITION AND INCOME
(\$ BILLION)

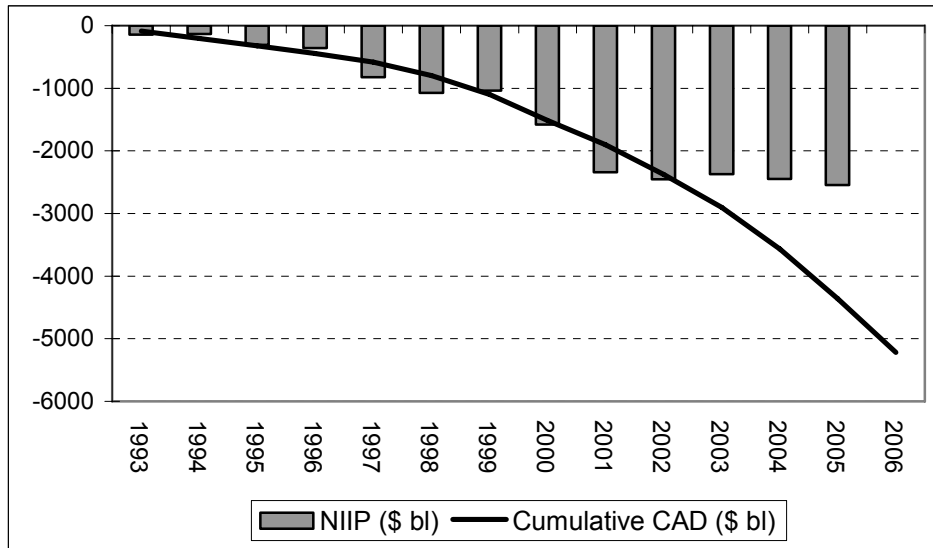


SOURCE: Bureau of Economic Analysis.

and Rey (2005) find that, historically, almost a third of U.S. external adjustment was realized through stabilizing valuation effects (the previously neglected “financial adjustment channel”) rather than through the traditional trade channel. It is noteworthy that the cumulative sum of U.S. current deficits from 1993, when the deficit started widening, to 2005 is \$4.4 trillion (\$5.2 trillion if 2006 is included), whereas the increase in the U.S. net international liabilities over this period amounted to just \$2.4 trillion (Figure 5).

⁵ In a variant, Hausmann and Sturzenegger (2005) argue that U.S. foreign assets would be much larger if measured by the present discounted value of future cash flows. By their calculation, the United States is a net creditor rather a net debtor.

FIGURE 5. U.S. NET INTERNATIONAL INVESTMENT POSITION AND CUMULATIVE CURRENT ACCOUNT DEFICIT, 1993-2006 (\$ BILLION)



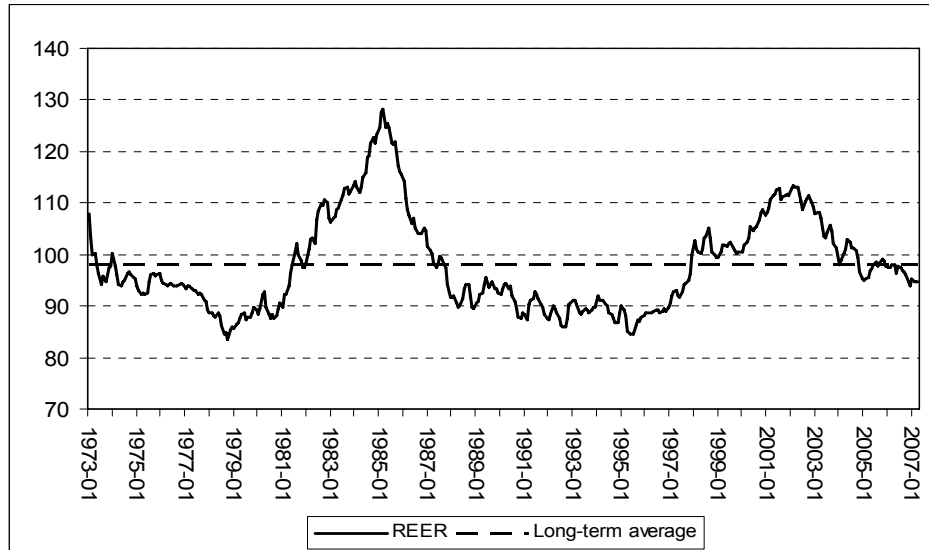
SOURCE: Bureau of Economic Analysis

III. Real-side models

Gloom-and-doom predictions about the global imbalances are usually based on real-side models that ignore capital flows and portfolio optimization. Simulations using these models tend to produce estimates of a very large dollar depreciation needed to reduce the U.S. deficit significantly. Recent simulations run by such models predict the need for dollar depreciation of between 8 and 25 percent in real effective terms to reduce the U.S. current account deficit from 7 to 3 percent of GDP – an arbitrarily defined “sustainable” rate (Cline, 2005; Ahearne et al., 2007). These estimates take it for granted that the current account deficit needs to be corrected, and that the only equilibrating variable is the exchange rate. In this approach, which focuses exclusively on trade flows, the adjustment process works through the global reallocation of demand between traded versus nontraded goods and domestic versus foreign goods. Because trade elasticities are low, this approach tends to produce large estimates of currency misalignments.

But is the dollar misaligned? The dollar depreciated by 16 percent in real effective terms since its peak in February 2002, and is now *below* its long term average (Figure 6). Real side models implicitly assume that the imbalances are caused by low U.S. competitiveness, when in fact they are caused by strong demand for U.S. assets, as I argue below. Dollar overvaluation is *not* the story here, and therefore calls for the abandonment of the U.S. “strong dollar” policy (e.g. Feldstein, 2006) are misplaced.

FIGURE 6. REAL EFFECTIVE EXCHANGE RATE OF THE U.S. DOLLAR
(MARCH 1973=100)



SOURCE: Federal Reserve Board broad index.

McKinnon and Schnabl (2006) have criticized these elasticity-based estimates as highly misleading. First, they are partial equilibrium estimates that ignore the deflationary pressures on U.S. trading partners from the appreciation of their currencies. Indeed, when Japan let the yen appreciate following the 1985 Plaza agreement, it ended up in a decade-long deflationary slump with no obvious decline in its large trade surplus. Second, the negative spillovers of currency appreciation on foreign incomes and absorption are ignored. Once the macro repercussions are taken into account, the effect on the appreciating country's trade balance is ambiguous. Third, it is not clear *how* these large real appreciations would be achieved. The impact of nominal appreciation on the real effective exchange rate would eventually be eroded by deflation, as happened in Japan. McKinnon and Schnabl conclude that the impact of massive dollar depreciation on the U.S. trade balance would be ambiguous, but the stability of the world economy would be seriously undermined.

IV. Portfolio balance models

With exchange rates increasingly determined in asset markets, some researchers have shifted the focus of their analysis from the current to the capital account. Portfolio balance models have been developed to analyze the impact of various shocks on global capital flows and interest rates. In Caballero et al. (2006), capital flows to the United States either because of its superior growth record relative to the Euro area and Japan, or because of the inability of emerging markets to produce reliable savings instruments with strong property rights. Both asset demand and supply are central to this analysis. On the demand side, U.S. assets are underpinned by the economy's cyclical outperformance and relatively high interest rates. On the supply side, the liquid, sophisticated and well-regulated U.S. financial markets attract a

large portion of cross-border flows seeking high risk-adjusted returns. By contrast, weak bankruptcy procedures, macro volatility and risk of default reduce the value of emerging market assets as claims on future output. In this model, interest rate or exchange rate adjustments can occur only if the growth differential between the United States and Euro area/Japan reverses (demand shifts), or if emerging markets develop their financial systems and start producing high-quality assets (supply shifts). Market reaction to U.S. data releases in recent years confirms that the main driving force for dollar movements is the U.S. growth and interest rate outlook rather than the trade deficit.

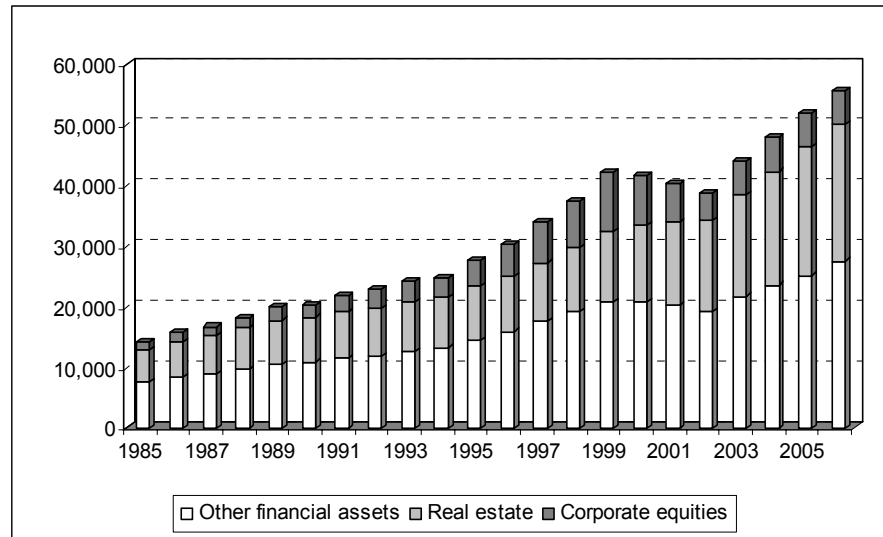
Cooper (2005) presents a similar view in terms of its main conclusions. He argues that the U.S. deficit is a natural consequence of two significant global developments, globalization of financial markets and demographic change, and that, far from being unsustainable, it is likely to persist for some time. He points to the fact that surpluses are produced by rapidly aging, high-saving societies like China, Germany and Japan that are unlikely to reduce their savings any time soon.

Since the deficit represents net foreign purchases of U.S. assets, the true test of sustainability is the portion of U.S. assets that foreigners will be willing and able to hold. Cooper proposes two thought experiments: The first assumes that the current account deficit continues indefinitely at (the then prevailing) \$600 billion a year. If the U.S. economy grows at 5 percent a year in nominal terms, the ratio of net foreign claims to GDP would rise for several years and peak at 50 percent in 15 years (67 percent at the current level of \$850 billion) and then decline. The second test is more severe, as it assumes that the U.S. current account deficit remains constant *as a percent of GDP* rather than in nominal terms; but that scenario also does not explode into unsustainability.

Gave et al. (2005) go a step further by arguing that the relevant indicator of current account sustainability is a comparison with U.S. *assets*, not GDP. Using the latest available figures in support of their argument, net private U.S. assets⁶ amounted to \$55 trillion at end-2006 – a figure that nets out all domestic and foreign debts (Figure 7). The annual capital inflow required to finance a \$850 billion current account deficit represents just 1.5 percent of this total. If net private U.S. assets (net worth) keep rising at the 6.3 percent average annual rate recorded during the past decade (a period that includes the 2000 tech sector bust), then the deficit would absorb (or rather *mortgage*) only about one-fourth of the annual increase in wealth. By implication, the U.S. current account deficit will remain sustainable at 6.5 percent of GDP and even at higher rates.

⁶ Net private U.S. assets include only the net assets (net worth) of households and non-listed businesses, since the net liabilities of listed companies and of the government are equal to the assets held by households or foreigners.

FIGURE 7. NET WORTH OF U.S. HOUSEHOLDS
(\$ BILLION)



SOURCE: Federal Reserve Board flow-of-funds accounts.

Put differently, U.S. net foreign liabilities amounting to \$2.5 trillion should be compared with net equity (net worth) of \$55 trillion, *not* with GDP of \$12 trillion. If the United States were a company, who would worry about its debt-equity ratio of 4.5 percent? And who would refuse to extend new credit? If we construct a thought experiment similar to Cooper's, in which both the current account deficit of \$850 billion and net U.S. assets of \$55 trillion grow at 6.3 percent a year indefinitely, the debt-to-asset ratio would rise gradually for decades from the current 4.5 percent and reach a plateau of 24.5 percent by the end of the century⁷. By then, foreign debt-to-GDP would be just over 100 percent, but this is not the proper yardstick of sustainability according to the authors. Obviously, a slower increase in net U.S. assets would encourage higher household savings and thus lead to a lower current account deficit – a self-equilibrating process.

As discussed above, Dooley et al. (2003, 2004) also argue that the current pattern of imbalances does not represent a threat to global economic and financial stability insofar as this pattern is optimal – and therefore sustainable – for all concerned. A corollary of this view is that a revaluation of the renminbi, far from helping to correct the imbalances, could trigger a financial crisis by upsetting the current “stable disequilibrium”. As I have argued elsewhere, the United States, Asia, and much of the Middle East are in effect part of the dollar zone, and therefore the imbalances between them are as irrelevant as those between Germany and Greece or Spain (whose imbalances are bigger than those between the United States and China relative to GDP). Obviously, if Asian countries change their strategy and

⁷ This calculation excludes positive valuation effects through the Gourinchas-Rey “financial adjustment channel”.

drop out of the dollar zone their currencies are likely to appreciate versus the dollar. But their incentive to do so while their financial systems remain underdeveloped, their reserves largely dollar-denominated, and regional monetary cooperation embryonic, is weak. Besides, the impact of such a move on global outsourcing trends or global imbalances is unlikely to be large, *inter alia* because Chinese wages still amount to just 3 percent of U.S. wages⁸. For purchasing power and import substitution effects to have a significant impact on savings-investment balances, dramatic shifts in exchange rates would need to occur that would damage China's growth prospects and test the system of "vendor financing" that helps fund the U.S. current account deficit. It is instructive that such concerns triggered an increase in U.S. Treasury yields in the wake of China's move to a managed float on 21 July 2005.

Portfolio models that come up with less sanguine conclusions suffer from the same shortcoming as those based on trade elasticities – namely, that the real exchange rate is the only equilibrating variable. Blanchard et al. (2006) construct a portfolio balance model in which the real exchange rate determines the allocation of both goods and assets between the domestic and foreign markets. In their model, increases in U.S. demand for foreign goods and in the foreign demand for U.S. assets are the two main forces behind the U.S. current account deficit. To restore equilibrium, the United States needs to generate a trade surplus to service the additional liabilities it issued in response to increased demand for U.S. assets. Restoring equilibrium in this model involves a large gradual depreciation of the dollar because the current account depends only on the real exchange rate, whereas relative growth rates do not enter the picture.

V. The "New Paradigm" view

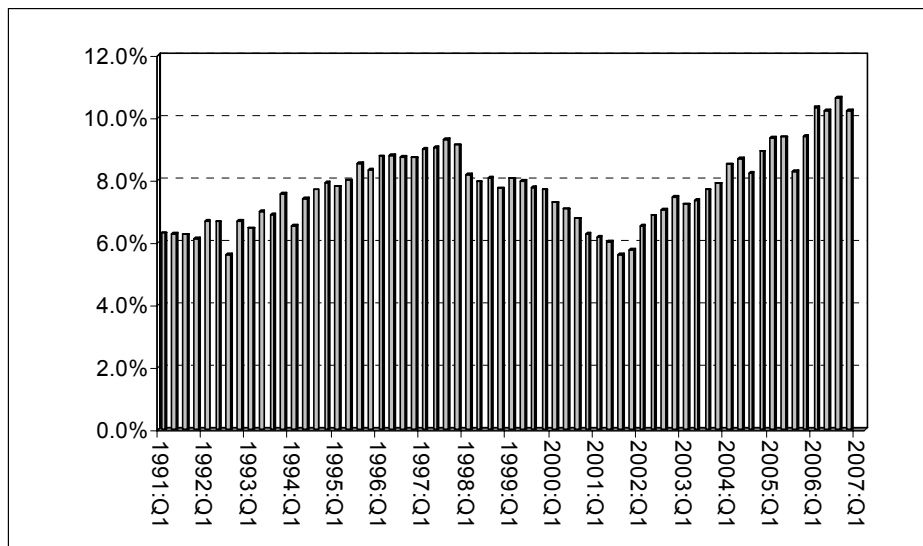
The global economy has undergone profound structural change over the past couple of decades. The collapse of the Soviet Union, Germany's reunification, and the greater integration of China, India, and other emerging markets with the world economy have created a global supply chain – a hugely positive supply shock. Despite some hiccups, macro policies and central bank credibility have improved over this period – especially in the 2000s – while financial innovations have helped spread risk more widely. The benefits of these events have been lower inflation, a more muted business cycle, and reduced volatility due to lower "boom and bust" fear in financial markets. This "new paradigm", in turn, has led to asset inflation and a reduction in financial returns (hence the "search for yield", as investors venture into new markets and products). These positive structural trends, which represent a break with the past, should be distinguished from cyclical components that are subject to reversal, such as global liquidity conditions and corporate leverage. The structural tailwinds – evidenced by the exceptionally low global inflation and interest rates – remain in place even

⁸ See U.S. Department of Labor, Bureau of Labor Statistics, "International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 2005", November 30, 2006.

though the cyclical headwinds are starting to be felt as U.S. GDP growth slows to a projected 2.6 percent in 2007 from 3.3 percent in 2006.

In their book “Our Brave New World” (2005), Gave et al. argue that the global economy has entered precisely such a period of exceptionally rapid wealth creation due to the more efficient use of labor and capital that globalization and information technology have permitted. The advanced countries have outsourced manufacturing to the developing countries while retaining the management and other service components of the production cycle. The “platform company” business model (e.g. Dell or Wal-Mart), specializing in design and marketing while outsourcing manufacturing – the most volatile and capital-intensive part of the production cycle – has had the dual effect on advanced countries⁹ of (a) taming the business cycle, thus encouraging private-sector leverage, and (b) leaving U.S. companies with excess cash, as their capital requirements have been reduced, giving rise to yet another puzzling development presumably stemming from globalization: The U.S. nonfinancial business sector has become a *net lender* in recent years, while publicly traded companies have used their excess cash to buy back their own shares (which presumably they thought were *cheap*) or engage in LBOs (for the same reason). U.S. companies also have increased their purchases of assets abroad, suggesting that one reason behind the relative weakness in capital spending at home is their increased financial investment overseas (IMF, 2006a).

FIGURE 8. U.S. SHARE OF PRE-TAX PROFITS IN GDP (%)



SOURCE: Bureau of Economic Analysis.

⁹ In fact, the authors have argued that we should stop calling Western countries “industrialized” and call them “Western service economies” instead.

Overall, the United States is getting a great deal: U.S. consumers get cheap products manufactured abroad, and U.S. companies make record-high profits (Figure 8). Gloomy predictions about sustainability are based on imbalances that measure *gross* trade flows, not *profits* (Gave et al., 2005). Before drawing conclusions about the sustainability of the U.S. trade deficit and its consequences for global economic and financial stability, it is relevant to ask: Who makes the most profits on the reported gross flows? If foreign manufacturers who export to the U.S. market have a razor-thin profit margin of 2 percent, while U.S. “platform companies” have a margin of 20 percent, it is clear whose assets market participants would rather own: The relative performance of the U.S. versus China’s stock market over the past decade provides some evidence to this effect, although it is distorted by China’s restrictions on share ownership. And, if anything, these profit margins have been diverging rather than converging as production and assembly is continuously moved to the cheapest producer while platform companies reap oligopolistic profits.

VI. Asset shortages

Caballero (2006) argues that there is a global shortage of financial assets, generated partly by the meltdown of a portion of Japanese assets in the early 1990s and emerging market assets during the crises of the late 1990s. The shortage was exacerbated by the rapid growth of savings in China and in commodity producing countries that do not generate financial assets on a sufficient scale to satisfy demand. As a result, the supply of financial assets has not kept pace with global demand for collateral and store of value by institutional investors, households, and other market participants. Asset shortages have contributed to “asset inflation”, low interest rates, and global imbalances. Such shortages are dollar-supportive because of the superior U.S. growth record and asset quality. And since asset bubbles are endemic to this environment, it is best to learn to manage the risks than risk bursting the bubbles. According to Caballero, the same recommendations apply to the global imbalances and to the liquidity consequences of low interest rates.

An interesting set of reports by Morgan Stanley (2007a, b) lends support to this hypothesis by analyzing asset supply and its regional breakdown. The authors note that robust global growth has improved fiscal positions everywhere, thus reducing issuance of sovereign debt and leading to a *decline* in total outstanding sovereign debt relative to GDP from a peak of about 65 percent of GDP in the mid-1990s to 59 percent now. Similarly, the value of net equity issuance globally *declined* by 34 percent in real terms. By region, the United States remains by far the largest issuer of equities since 2000, followed by Asia ex-Japan (AXJ). Issuance has been moderate in the Euro area and low in the UK, Japan and Latin America. With Hong-Kong the premier Asian financial center, underpinned by its dollar peg, the dollar block offers by far the largest supply of high-quality assets for global investors; it is thus hardly surprising that much of the world’s excess savings are invested there. By contrast, the supply of U.S. corporate bonds is constant or declining as a percent of GDP, reflecting the cash-rich position of U.S. corporates, while it is rising in the Euro area but from very low

levels. The authors suggest that the surge in financial innovations, such as credit derivatives, is a case of strong demand for risky assets generating its own supply.

Demand-side factors also have helped fuel the asset shortage. The universe of eager buyers of low-yielding assets has been widened by three developments: One is the “global savings glut”, partly triggered by the export-oriented strategy of Asian countries discussed above, which forces Asian central banks to buy U.S. bonds irrespective of relative returns. But there are two additional big buyers: Japanese investors and Western pension funds. Japanese investors consider U.S. Treasury and Agency returns quite high, at a time when Japanese government bond yields barely exceed 1 percent while the yen is *depreciating*, partly as a result of the yen carry trade that involves shorting the yen to buy higher-yielding currencies. Moreover, for regulatory reasons, developed market pension funds and insurance companies (mainly in the U.S. and U.K.) are increasing their holdings of fixed-income securities while reducing their share of equities in order to match their assets more closely with their long-term liabilities. The impact of the 2001 recession on these institutions, which were overweight in equities on the asset side and long duration on the liability side, was a double-whammy of poor equity returns and falling bond yields that hurt both sides of their balance sheets.

VII. An abrupt unwinding is highly unlikely

The traditional view of global imbalances is based on the notion that the U.S. current account is unsustainable because it leads to an accumulation of foreign liabilities that will inevitably lead to a loss of market confidence. This view assumes that (a) adjustment induced by policy actions is more likely to be orderly than one initiated by financial markets; (b) financial markets are likely to change their minds abruptly about the sustainability of the imbalances, unless they see that the main players are able to agree on the direction of the desired policy changes.

I would question the validity of both assumptions for the following reasons:

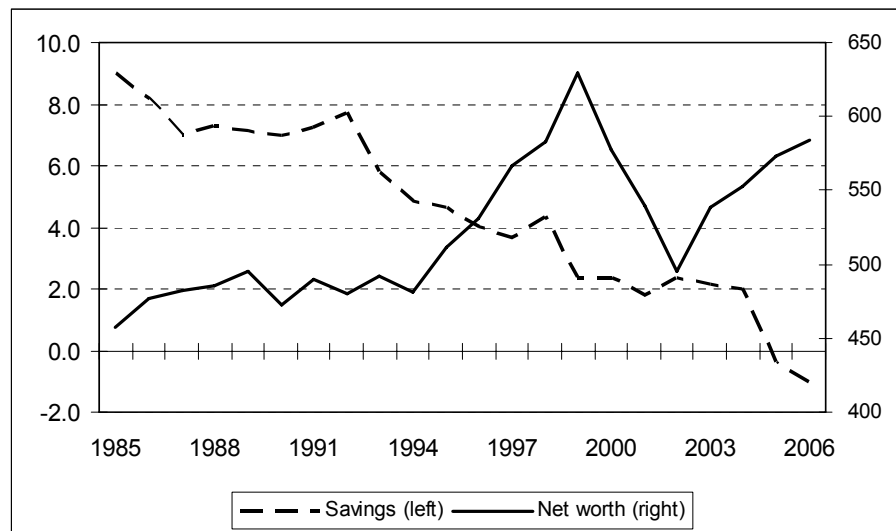
(1) There is no historical precedent of disorderly exchange rate adjustment in industrial countries that keep inflation under control and have a well-regulated financial system (Croke et al., 2005). As shown in Figure 2, foreign appetite for U.S. assets remained unabated even in the absence of any joint action to address the imbalances in 2000-06.

(2) Unlike “sudden stops” in emerging markets, there are no close substitutes to U.S. assets on the scale necessary to trigger a dollar crisis. The United States enjoys a dominant position as supplier of financial assets globally because of the unique depth and efficiency of U.S. capital markets and their attractiveness as a profitable and safe investment destination. Moreover, the U.S. current account deficit provides needed dollar liquidity to the rest of the world, and thus constitutes an integral and sustainable feature of a dollar-centric international monetary system.

(3) Global imbalances are on their way to being corrected through the normal functioning of markets as global growth becomes more balanced, with the U.S. economy slowing and the Euro area and Japan picking up. There are signs that the correction already is underway, as the U.S. current account deficit declined to 5.8 percent of GDP in 2006:Q4 from a peak of 7.0 percent of the GDP a year earlier.

(4) Part of the adjustment will come from an increase in the (officially measured) U.S. saving rate. First, the U.S. fiscal deficit is projected to fall to 2.5 percent of GDP in 2007 from a peak of 4.8 percent in 2003. Second – and more importantly – “asset inflation” will eventually slow and U.S. households will start saving out of their incomes instead of relying on capital gains to increase their wealth (Figure 9). The traditional view considers that the remarkable growth in U.S. household net worth over the past decade is a mirage, reflecting asset bubbles in the equities and housing markets generated by an excessively accommodating Fed policy that encouraged reckless risk-taking both during and after the tech sector boom and bust of the late 1990s¹⁰. By contrast, the new paradigm view draws attention to the unexpected surge in productivity and disinflation since the mid-1990s that lowered real long-term interest rates and raised the value of long-term assets (Lipsky, 2007).

FIGURE 9. U.S. HOUSEHOLD SAVINGS AND NET WORTH
(% OF DISPOSABLE INCOME)



SOURCES: Federal Reserve and Bureau of Economic Analysis.

¹⁰ Stephen Roach summarized this perspective as follows: “From bubble to bubble - it’s a painfully familiar saga. First equities, now housing... And once again, twin bubbles in a particular asset class and the real economy are in the process of bursting, most likely with greater-than-expected consequences for the U.S. economy, a U.S.-centric global economy, and world financial markets” (Morgan Stanley, 2007c).

The first view regards the U.S. economy as flirting with recession and hard landing, whereas the second view predicts a market-led, smooth unwinding of imbalances.

(5) Just how small a probability markets attach to the abrupt unwinding scenario is reflected in asset price movements. The dollar's gradual fall since its peak in February 2002 has been remarkably benign in terms of its impact on financial markets, since it has been accompanied by a *decline* in 10-year Treasury yields from 4.89 percent at end-February 2002 to 4.61 percent at end-April 2007). Markets continue to view U.S. Treasuries as a risk-free asset that benefits from "safe-heaven" flows. In the two most recent risk-reduction episodes (May-June 2006 and Feb-March 2007), flight to quality was associated with dollar *appreciation*, contrary to the predictions of the traditional view. And the forward discount of the dollar versus major currencies is small or negative.

VIII. Conclusion

Gloomy predictions about the unsustainability of the U.S. current account deficit and its dismal consequences for the dollar and interest rates, repeated year after year, have failed to materialize and are unconvincing. Who is to tell financial markets what is sustainable and what is not? Markets can be wrong for a while, as they were in the tech boom and bust of the late 1990s, but they cannot be wrong for more than a decade. Financial innovations have improved the pricing, repackaging, and spreading of risk, and better supervision and risk management practices also have contributed to more resilient financial markets (IMF 2006b). Globalization – both real and financial – has improved productivity while reducing "home bias" in investment decisions. The result has been an unprecedented and sustainable increase in global wealth.

The rise in the U.S. current account deficit, the shift to surplus of emerging market countries, and the low long-term real interest rates appear as anomalies in the traditional view. But once capital flows are endogenized as functions of risk-adjusted returns and diversification opportunities, global imbalances become an equilibrium outcome of differences in potential growth rates and asset supplies across different countries and regions. The portfolio balance models constructed by Blanchard, Caballero, Dooley and their co-authors do not give rise to any catastrophic events. Instead of a crash landing, I have argued that the imbalances are on their way to being corrected by the normal functioning of markets, and that the lack of appetite for any concerted policy action by the major players should therefore not be cause for concern.

Indeed, the biggest threat to the dollar and to global financial stability does not come from the global imbalances *per se*, but from the protectionist pressures they may trigger. The U.S. decision to impose countervailing duties on imports of certain Chinese products in March 2007 triggered an immediate increase in speculative short positions against the U.S. dollar. The IMM Commitment of Traders report showed a \$4 billion jump in these positions to \$18

billion within a week, notably against long Euro positions. This reaction underscores the view that it is policymakers, not market participants, who are more likely to upset the existing “stable disequilibrium”.

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