Global Imbalances as the Cause of the Crisis?

Aleš Lokaj
VŠB – Technical University of Ostrava
Faculty of Economics, Department of Economics
Sokolská 33
Ostrava, 701 21
Czech Republic
e-mail: ales.lokaj@vsb.cz

Abstract
Many authors in recent years have researched links between the global imbalances and financial crises. Some authors argue that the global imbalances of the 2000s and the "recent" global financial crisis are intimately connected because the origins of both problems are in economic policies followed in a number of countries in the 2000s, in distortions that influenced the transmission of these policies through United States of America and ultimately through global financial markets. Other authors argue that the capital inflows into the United States associated with the current account deficit were also not the key factor driving foreign purchases of US toxic assets and those macroeconomic policies that reduced global imbalances could have been adopted but these would probably not have prevented the crisis. The aims of this paper approach the views of different authors on the links between the global imbalances and financial crisis and efforts to answer the question: Did global imbalances cause the "recent" financial crisis or not?

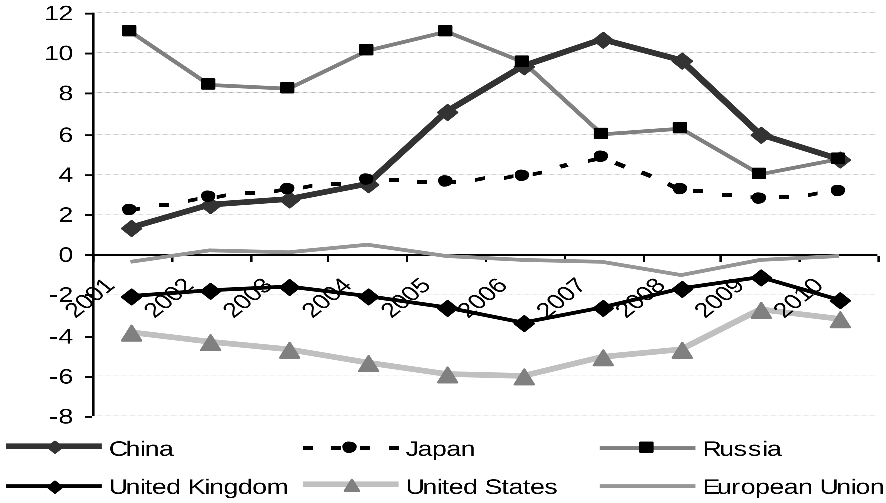
Keywords: global imbalances, global financial crisis, current account, United States of America
JEL codes: global imbalances, global financial crisis, current account, United States of America

1. Introduction

The period from 2004 – 2007 were specific by a strong economic performance of countries around the world – characterized by high economic growth, generally low inflation, expanding international trade and financial flows. We can see in figure 1 and 2 on selected countries: the United States and the Great Britain represent countries with current account deficit, China, Japan and Russia are representatives of the current account surplus, and European Union has a relatively balanced current account deficit. Gross domestic product significantly decreased in all countries. This situation was also accompanied by the following trends: real estate values were rising at a high rate in many countries (mainly in the United States of America), number of countries were simultaneously running high and rising current account deficits (including the world's largest economy – the United States), leverage had built up to extraordinary levels in many sectors across the globe (especially among consumers in the United States and Britain and financial entities in many countries. The global economy has, since the second half of 2007, experienced a deep financial crisis. This has been reflected in significant falls in asset prices, a sharp contraction in global output and precipitous falls in international trade flows. The global imbalances did not cause the leverage and housing bubbles, but they were a critically important codeterminant (Obstfeld and Rogoff, 2009). Ben S. Bernanke (2009) said: *"In my view…it is impossible to understand this crisis without reference to the global imbalances in trade and capital flows that began in the latter half of the 1990s."*

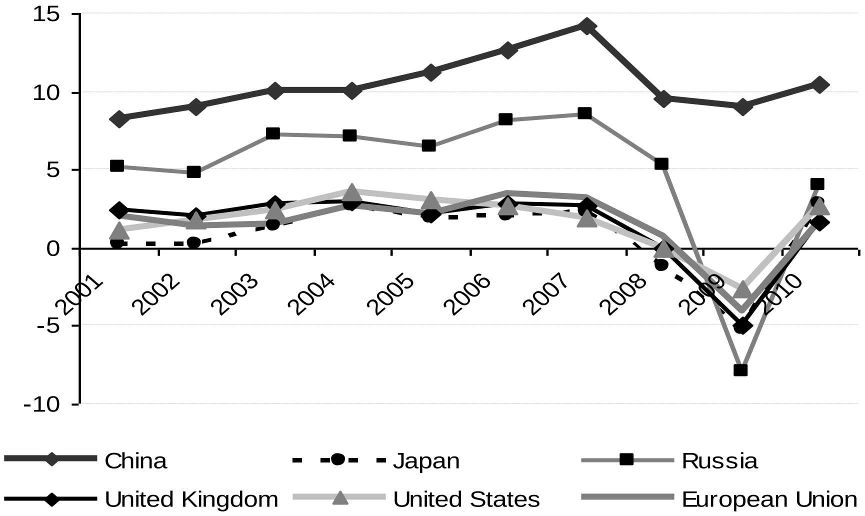
First part of the paper is focus on the theoretical definition of global imbalances and their short history in 20th century and the beginning of the 21st century. Second part of the paper discusses causes of global imbalances from the perspective of many different authors and possible links with the "current" financial crisis.

Figure 1: Current Accounts (as % of GDP) of Selected Countries from 2001 to 2010



Source: World Economic Outlook – IMF 2011

Figure 2: GDP growth (in %) of Selected Countries from 2001 to 2010



Source: World Economic Outlook – IMF 2011

2. Global Imbalances

Before the analysis of the links of global imbalances and financial crisis, it is necessary to define the concept of global imbalances. Bracke et al. (2008) defined global imbalances as: *External positions of systemically important economies that reflect distortions or entail risks for the global economy*. Now shortly analyze the individual parts of definition. "*External positions"* refers not only to current account balances but also to financial positions. *"Systemically important economies"* these are economies whose macroeconomic and financial developments may have a significant impact on the global economy. *"Reflect distortions"* the build-up of external positions may (partly) reflect distortions, i.e. deviations from the equilibrium that would prevail in an environment of full price flexibility and perfect competition. *"Entail risks for the global economy"* the existence of external positions may pose risks for the global economy, both under a scenario of unwinding (risk of disorderly unfolding with disruptions to macroeconomic and financial stability) and a scenario of further increasing imbalances (risk of a protectionist backlash) (Bracke et al., 2008).

2.1 Short history of Global Imbalances

Global imbalances have existed since the beginnings of international trade. Countries characterized by high production capacities exported to foreign countries, which positively affected the current account balance. On the contrary, countries that imported goods formed the current account deficits. Great Britain, France and Germany were the countries with the largest current account surpluses in the beginning of twentieth century. These countries have lost their status as leader of foreign trade during and after World War II and get into opposite position. Mainly due to Marshall Plan became United States of America the world's largest creditor. U.S. dominance as the biggest creditor took primarily in the Bretton Woods system; the current account surpluses also begun to achieve Germany and Japan during this period. The end of Bretton Woods system, the oil crisis in the seventies and the growing indebtedness of countries in South America in the eighties, which was funded primarily by U.S. banks, tax cuts under the Reagan administration and consequent inflow of investments into the country led to a change in the position of the United States. Since 1982 United States of America are in the position of the debtor.

End of the 20th century was a specific by growing importance of Asia region, high occurrence of financial crises in South America, Southeast Asia and also in many other developing countries. And it was the Asian crisis and subsequent economic policy supporting exports in these countries led to the growth of current account surpluses in these countries and consequently savings. Important (or main) role have played China. Since end of the 20th century changed the role between creditors and debtors in international trade, which documents the following table 1.

Table 1: Change the role between advanced and emerging countries during 20th century

Time period	Creditor	Debtor
Gold Standard	Advanced	Emerging
Bretton Woods	-	-
1970s	Emerging	Emerging
1980s	Advanced	Advanced
1990s	Advanced	Emerging
2000s	Emerging	Advanced

Source: Bracke et al. (2008)

2.2 Causes of Global Imbalances

The table 1 and figure 1 show that in these days' creditors are mainly emerging countries (like China, countries from Southeast Asia region, Japan and countries exporting oil) and debtors are manly advanced countries like United States of America, Great Britain and European Union. What are the causes of this situation and this change the roles. Blanchard and Milesi-Ferretti (2009) argue that current account balances reflect a plethora of macroeconomic and financial mechanisms and in a global world, there is no reason for current accounts to be balanced. Indeed, it is desirable for saving to go where it is most productive, and imbalances can therefore emerge naturally from differences in saving behavior, in the rate of return on capital, or in the degree of risk or liquidity of different assets. The authors argue that there are "good" imbalances and "bad" imbalances that pose domestic distortions, systemic distortions, domestic risks and systemic risks. Blanchard and Milesi-Ferretti (2009) defined "common" causes of global imbalances. But what are the causes of the current large global imbalances enhance?

Gruber and Kamin (2006) defined seven main causes of the current deepening global imbalances. Many other authors agreed to a number of causes, which will also set out below. The first cause is: *Expansion of the fiscal deficit*. Many countries, especially United States of America reached "twin deficit" hypothesis. At its simplest, this hypothesis notes that the current account balance is equal to saving minus investment, so any expansion of the fiscal deficit that lowers public saving must lower the current account balance respectively fiscal expansion boosts domestic spending, pushing up domestic interest rates relative to foreign rates – this attracts foreign investors and buoys the dollar, thereby widening the current account deficit. Chinn (2005) sees the state budget deficit of the United States as an important factor that affects the external imbalance. Smaghi (2008) notes, that the external imbalance is often a reflection or predictions of internal imbalances.

The second cause is: *Declines in private saving rates.* By Gruber and Kamin (2006) personal saving rate in United States has moved down from about 5 percent of disposable income to below 2 percent. However, it is clearly obvious that the decline in savings is autonomous and reflects itself in financial innovation on the market that allow easier borrowing of U. S. households, or whether the endogenous reaction. Ferguson (2005) documented in their model situation that decline in private savings and rising interest rates crowd out investment more than net exports.

Next cause by Gruber and Kamin (2006) is: *U.S. productivity surge.* These authors argued, that growth rate of U.S. labor productivity rose from 1,5 percent in 1975 to about 3 percent in 1995. Higher labor productivity attracted foreign investors, which influenced exchange rat of U.S. dollar. Expectations of higher rates of return also motivated domestic entities to invest. Resulted were growth of domestic consumption and stock prices.

The fourth cause is: *Expanding global financial intermediation.* At the end of the 20th century has begun the larger international movements of capital, i.e. many households and investors leave earlier tendency when was dominated in their portfolio domestic assets. This fact also takes Lane and Milesi-Ferretti (2006). Also Whelan (2010) argue that in the period 2002 – 2007 increased foreign liabilities of the United States from the original 83 percent of GDP to 147 % of GDP. However, only a third of this increase was attributed to the increasing current account deficit of balance of payments, the remaining growth fell at the expense of financial globalization.

The fifth cause by Gruber and Kamin (2006) is Bernanke's: *Global savings glut/emerging market financial crises.* Bernanke (2005) argued that the large U. S. current account deficit owes importantly to a surge in the availability of saving from overseas. He noted that much of the increased flow of foreign saving has come from developing countries, a development he attributes in large part to the series of financial crises experienced in the past decade. Reasons for this situation are many. Gruber and Kamin (2006) explanation for the increased flows of capital from developing countries see in highly developed financial market in the United States of America. In the opinion of UNCTAD (United Nations Conference on Trade and Development) is the causality between investment and savings opposite. It means that savings have been created to be invested in the United States of America. The U. S. problem is not too low level of household savings, but excessive consumption of imported goods. It could be illustrates on the fact that industrial production in the United States increased between 2002 and 2005 by 5 %, while consumption of durable goods in the same period grew by 30 % (Švihlíková, 2008).

The next cause by Gruber and Kamin (2006) is: *Developing Asian exchange rate intervention.* Other explanation of the high current account deficit of United States (and high current account surpluses of Asian countries) can be in intervention in exchange markets, which aim to maintain an undervalued fixed exchange rate and thereby increase the competitiveness of Asian goods and higher economic growth. The International Monetary Fund recommends rather floating rates and monitors especially the Chinese Yuan appreciation. UNCTAD emphasizes the existence of speculative capital flows, and thus calls into question the ability of floating rates to compensate current and financial account without central bank intervention. Organization considered that the nominal exchange rate is the most important economic indicators, which leads to a distortion of free trade and its poor setting becomes a subsidy or duty (Švihlíková, 2008).

The last cause by Gruber and Kamin (2006) is: *Rising oil prices.* Relatively high economic growth reflected in rising prices of raw materials (especially oil) – leads to greater widening of the gap between deficit and surplus countries (mainly oil-producers). This factor is not fundamental explanations for the large U.S. deficit as the other reviewed above, but, however, between 1996 and 2004, oil imports rose by nearly 110 billion U.S. dollars, and this increase was mainly due to increased raw material prices.

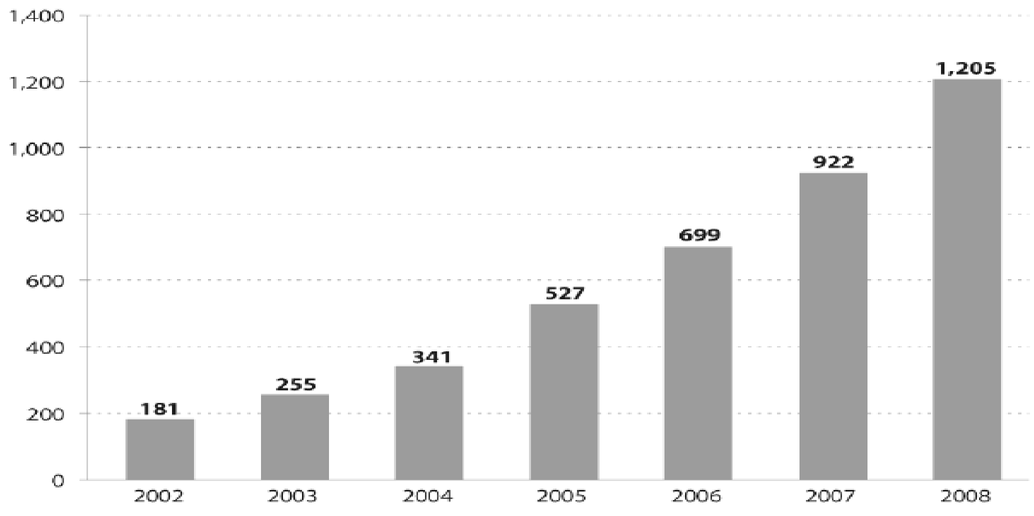
So this was the main cause of the deepening global imbalances especially in the last fifteen or twenty years. Some authors argue that many of these factors, more or less, related to the problems of the current financial crisis. For example Smaghi (2008) said that "the financial crisis and global imbalances are two sides of the same coin". Obstfeld and Rogoff (2009) in their paper wrote that:

“Global imbalances and financial crises are closely linked”. Carney (2009), Governor of the Bank of Canada, is considered “high and unsustainable current accounts of key economies in the world as an integral part of vulnerabilities in many asset markets”. Perhaps the “strongest” claim is a statement by Portes (2009), the President of Centre for Economic Policy Research that “global macroeconomic imbalances are the root cause the crisis“ or “that global imbalances brought low interest rates and search revenue associated with excessive amounts of financial transactions that the system could not manage responsibly. But can we clearly say that the crisis caused by global imbalances?

Many of the above arguments, it is undoubtedly true, but the opinion of other authors is the impact of global imbalances to financial crisis too exaggerated. Many authors argued that the global imbalances caused huge surplus of U.S. dollars held by China and the investment return led to a decline in interest rates in the U.S. With this argument it is necessary to agree, but from the perspective of households, is it really necessary to further indebt just because it's better now? If the financial literacy of the U.S. population has been developed - would be there so high indebtedness and increase the number of mortgages? Or does not Federal Reserve System have sufficient instruments of monetary policy that would prevent drastic interest rate cuts? Or rather was it A. Greenspan monetary policy, which allowed the reduction of rates?

Further, Obstfeld and Rogoff (2009) point to the problem of purchase “toxic” U.S. securitized mortgage packages with European banks, which have paved the source of external financing the current account deficit of the United States of America. These "toxic" securities caused the transfer of the financial crisis in Europe. According to estimates by the International Monetary Fund (April 2010) were writing off debts caused losses of the securities calculated at roughly $ 2.3 trillion (with the share of U.S. banks is about $ 885 billion and the share of European banks is approximately 1.3 trillion dollars, the remaining assets owned by Asian banks). However, Whelan (2010) notes that during this period, the mutual trade between Europe and the United States is relatively balanced. Even if the United States an equal balance with the rest of the world, very likely would not discourage European banks from buying these "toxic" securities. The motivation is to reap higher at relatively high rating securities. On the other hand, balance of trade between the U.S. and China in 2007 reached nearly 300 billion U.S. dollar (roughly 2% of U.S. GDP) was not financed by Chinese purchases of "toxic" securities, as was the case of European banks. In fact, the Chinese buy more U.S. Treasury bonds, as evidenced by Figure 3, which in 2007 increased the number of American securities held by China, by 223 billion USD (Morrison and Labonté, 2009). Why China bought mainly U.S. Treasury bonds and not toxic assets?

Figure 3: U.S. securities held by China between 2002 and 2008 (in billion USD)



Source: Morrison and Labonté, 2009

Smaghi (2008) said that “if the United States had adopted measures to improve net savings, in particular by households, as suggested, the housing bubble would have been more limited and it’s bursting less dramatic”. Against this opposed Whelan (2010), when he said: “if the United States had adopted policies to encourage private savings, it is likely that much of this additional savings would have been channeled towards some of the toxic vehicles that helped to fund the housing bubble. Indeed, one could possibly argue that every dollar spent by U.S. households on Chinese imports – subsequently re-cycled to purchase U.S. Treasury bonds – would have contributed less to the financial crisis than a dollar saved”.

Obstfeld and Rogoff (2009) argued that the macroeconomic policies of United States that lead to the global imbalances also lead to the financial crisis. If macroeconomic policy was different and would lead to the growth of savings in United States and decrease savings in Asian countries, can reliably say that no financial crisis occurred?

3. Conclusions

Historically, there is always an accumulation of current account surpluses for countries that are technologically advanced (achieve higher productivity of capital or labor) or were able to produce at lower costs, etc. This is a natural state, or "good" imbalance, which has always existed - it changes only composition of countries that achieve these surpluses or deficits, depending on the development of world economy and events. In recent years, however, the gap between surplus and deficit countries widen significantly. The main causes of the deepening global imbalances, which relate primarily to the United States of America - a country with the largest current account deficit and China - countries with the largest current account surplus - can be considered mainly the following two factors.

High consumption of households and government spending in the United States. The reason for high consumption was also undoubtedly a long-term low interest rate, which was caused among other things, high supply of U.S. dollars, which cashed in Asian countries for their exports. The very fact low interest rates should not decide on reckless purchases or loans and thereby promote excessive consumerism. Therefore, rather than the global excess savings in Asian countries is particularly problematic in high consumption of imported products by U.S. households, and high government spending. If the demand for imported products is lower, certainly there would be so large surpluses, which would increase the amount of U.S. dollars held by Asian countries, and thus kept as low interest rates.

Undervalued courses especially Asian currencies, led by the Chinese Yuan. Keeping undervalued countries achieve high rates of exports and thus influx of mainly U.S. dollars into the country, as goods of these countries is relatively cheaper than the countries of others. Modification of these courses would reduce global imbalances. Probability "more realistic" peer exchange rate is almost zero, as the countries with undervalued exchange rate would not be willing to give up their advantages in favor of reducing global imbalances.

In my opinion can not say that global imbalances cause financial crises. More fundamental shortcomings can be seen more irresponsible in household debt and consumer life in the United States, "hunger" mainly European banks reach so highest yields and insufficient compliance with banking regulations of the Federal Reserve System. The financial crisis would very likely was, even assuming that global imbalances were gradually eliminated.

References

Citation of a journal paper
ŠVIHLÍKOVÁ, I. (2008). Globální nerovnováha a její dopady. *Pro a proti*, vol. October 2007/2008, no. 25, pp. 1–7.

Citation of a working paper
BLANCHARD, O.; MILESI-FERRETTI G. M. (2009). *Global Imbalances: In Midstream?* Working paper SPN/09/29, International Monetary Fund.

BRACKE, T.; BUSSIÈRE, M.; FIDORA, M.; STRAUB, R. (2008). *A Framework for Assessing Global Imbalances.* Occasional paper series No. 78/January 2008, ECB.

GRUBER, J. W.; KAMIN, S. B. (2005). *Explaining the Global Pattern of Current Account*. International Finance Discussion Papers, number 846, Board of Governors of the Federal Reserve System, November 2005.

CHINN, M. D. (2005). *Getting Serious about the Twin Deficits*. New York: Council on Foreign Relations, 2005. CRS No. 10.

LANE, P. R.; MILESI-FERRETTI, G. M. (2006). *The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970 – 2004*. IMF Working Paper WP/06/69, Washington: IMF.

MORRISON, W. M.; LABONTE, M. (2009). *China's Holdings of U.S. Securities: Implications for the U.S. Economy*. CRS Report for Congress RL34314, Congressional Research Service, Washington.

WHELAN, K. (2010). *Global Imbalances and the Financial Crisis*. Working Paper Series WP10/13, University College Dublin.

Citation of other sources
BERNANKE, B. S. (2005). *The Global Saving Glut and the U.S. Current Account Deficit.* Remarks at the Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia, 2005.

BERNANKE, B. S. (2009). *Financial Reform to Address Systemic Risk.* Speech at the Council on Foreign Relations, Washington, D.C., 2009.

CARNEY, M. (2009). *The evolution of the international monetary system.* Remark to the: Foreign Policy Association, New York, 19th November 2009. Bank for International Settlements.

FERGUSON, R. W. Jr. (2005). *U.S. Current Account Deficit: Cause and Consequences.* To the Economics Club of the University of North Carolina at Chapel Hill. Chapel Hill, North Carolina, 20th April, 2005. The Federal Reserve Board.

OBSTFELD M.; ROGOFF K. (2009). *Global Imbalances and the Financial Crisis: Products of Common Cause.* Asian Economic Policy Conference, October 18-20, 2009. Santa Barbara, California.

PORTES, R. (2009). *Global Imbalances*. London Business School and CEPR, London.

SMAGHI, B. L. (2008).*The Financial Crisis and Global Imbalances: Two Sides of the Same Coin.* Speech at the Asia Europe Economic Forum, Beijing, 8 – 10 December, 2008. Bank for International Settlements.