GLOBAL MONETARY AND FINANCIAL DISORDER:

THE ROLE OF THE GLOBAL IMBALANCES

Martin Wolf[1]

"[T]he years since the early 1970s are unprecedented in terms of the volatility in the prices of commodities, currencies, real estate and stocks, and the frequency and severity of financial crises." Robert Aliber.[i]

"The current financial crisis in the US is likely to be judged in retrospect as the most wrenching since the end of the second world war." Alan Greenspan, Financial Times, March 16th 2008.

"Inflation is always and everywhere a monetary phenomenon. Milton Friedman."

Two storms are simultaneously buffeting the world economy: an inflationary commodity-price storm and a deflationary financial one. What explains this combination of a "credit crunch" in the US with soaring commodity prices and rising inflation across the globe? Are these unrelated events or part of a bigger picture?

The answer, I am going to suggest, is the latter: they are related. In particular, they are related via two phenomena – the global savings glut and the global "imbalances" or pattern of current account surpluses and deficits – that are themselves, at least in part, the result of a dysfunctional global monetary *cum* financial system. Furthermore, I will argue, these imbalances are the result of a "fear of deficits". This is itself the consequence of the failure of the global monetary cum financial system to transfer capital to emerging economies safely.

Revival of inflation

Inflation is a sustained rise in the price level: the result of too much money (or purchasing power) chasing too few goods and services. A one-off jump in commodity prices is, of course, not inflation. Nor need such a jump cause inflation. Yet a *continuous* rise in the relative price of commodities is a symptom of an inflationary process. Whenever excess demand hits, the goods whose prices rise first are those with flexible prices, of which commodities are the prime example. Commodity prices

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then are a pressure gauge. If we look at what has been happening in recent years, the gauge is showing red.

The Goldman Sachs index of commodity prices has doubled since early 2007. The upward movement in commodity prices has persisted for more than six years. It looks indeed as though too much extra demand is pressing on too little ability to increase global supply.

Inflation is the result of too much demand chasing too few goods and services: put simply, the world economy has been growing faster than, with present technology and resources, it can sustainably do. The ability to expand supply is, of course, a real phenomenon. The supply of energy is the most important of all real economic phenomena. Our industrial civilisation is, after all, based entirely on fossil fuel.

Since the end of 2001, the real price of oil has risen some six-fold. Today, it is higher than since the beginning of the previous century. As the World Bank notes in its Global Development Finance 2008, global oil supply stagnated in 2007. This, argues the report, "contributed to the large decline in stocks in the second half of 2007 and to sharply higher prices"*. These increases may prove temporary, as happened after the spikes of the 1970s, permanent or, worst of all, ongoing. We do not yet know.

The result of the pressure of demand on supply has been unexpectedly big increases in overall inflation: the consensus for world consumer price inflation in 2008 has jumped from the 2.4 per cent forecast in February 2007 to the 4.3 per cent forecast in June 2008. The jumps in the inflation expected in 2008 are considerably bigger than this in the emerging economies, where the weight of food in consumption is particularly high.

Yet how can we have what seems to be incipient global inflationary process when the US economy and those of other significant high-income countries are slowing down? The proximate reason is that the latter matter less than they used to. The underlying explanation is to be found in the forces driving both global demand and supply.

Role of imbalances

On supply, I have nothing further to add to what I have just said. On global demand, however, two big things are happening: convergence and the consequences of the imbalances. Under convergence comes the accelerated growth of emerging economies, above all of China and India. Under imbalances come the interventions in currency markets aimed at supporting competitiveness.

Charles Dumas of London-based Lombard Street Research notes that, at purchasing power parity, China now generates a little over a quarter of world economic growth in a normal year, while emerging and developing countries together generate 70 per cent. Even at market exchange rates, the growth of China's gross domestic product is as big as that of the US, in normal years for both countries.

This is a fundamental transformation in the balance of the world economy. The emerging countries are also in a good position to keep on growing, largely because they have such strong external positions. The reason this is important for global inflation is twofold: first, the growth patterns of these economies are extremely resource-intensive – China, for example, uses almost as much energy as the US despite having an economy that is half the size at purchasing power parity and a quarter at market exchange rates; second, these economies are continuing to grow very fast, even though the US and, to a lesser extent, other high-income countries are slowing down.

This brings me to the second point, the savings glut and the role of imbalances, which I discuss at length in a forthcoming book, *Fixing Global Finance*. We need to understand two things that have happened.

First, as Ben Bernanke correctly argued, a global savings glut emerged over the last decade. The single best indicator of that glut has been the low real rate of interest at a time of fast global economic growth. Behind this glut lie three phenomena – the savings surpluses or, more precisely, excess of retained profits over investment, of the corporate sectors of the advanced countries, the persistent savings surpluses of a number of mature economies, particularly Japan and post-post-unification Germany and, last but not least, the switch of the emerging economies into ever large current

account surpluses. The latter, in turn, has had three elements: the shift of crisis-hit emerging countries from deficit into surplus, particularly after the Asian financial crisis, the rise of China as the world's largest capital exporter, despite also being the world's biggest investor and, more recently, the surpluses of the oil exporting countries. China's current account surplus equals those of Germany and Japan combined.

In aggregate the forecast current account surpluses of the twenty largest surplus countries is forecast by the International Monetary Fund at about $1,700bn this year. My back of the envelope calculations suggest that these surpluses are equal to about a seventh of world gross saving and close to twice as large a share of the savings of the capital surplus countries themselves: these capital flows then are enormous.

What have been the consequences of the emergence of savings gluts concentrated so heavily in a relatively small group of countries? I will discuss just two.

First, it should go without saying that the world balance of payments or patterns of savings surpluses and deficits must add up to zero. This reality is sometimes forgotten even by economists who take pride in the frugality of their own country and condemn the profligacy of those who spend what their own citizens choose to save.

In practice, they have added up over the past decade as a consequence of the responsiveness of household savings and spending in a relatively small number of high-income countries of which the US was far and away the most important. This spending was further stimulated by the rapid rise in house prices that were the result of the low real interest rates, low inflation and so low nominal interest rates and extremely elastic supply of credit. A long period of economic success – the "great moderation" no less - bred huge excess. The elasticity of credit, stimulated by low real interest rates and financial innovation, allowed the US household sector (and also that of the UK) to run unprecedently large financial deficits over a long series of years. The result, we already know, is the financial crisis we see today.

As Harvard's Kenneth Rogoff has argued, this is just another emerging market crisis, but this time the emerging market was found inside the US. It also is another reminder of why large net capital flows have proved so destabilising: they only work if the borrowers are making investments able to service the loans. This is just as true if the borrowers are insie the US as if they are in emerging economies. In this case, unlike in emerging market economies in the 1980s and 1990s, there was no currency crisis. But there was a crisis in the domestic counterpart of the external capital flows.

Meanwhile, what has been going on in the providers of capital? In the case of the emerging economies, the answer is that they have been intervening in their currency markets on a simply enormous scale. Over the seven years to March 2008, global foreign currency reserves jumped by $4,900bn, with China's reserves alone up by $1,500bn. Almost all of this increase was in emerging countries who have engaged in what is surely the biggest "self-insurance" programme in world economic history. Indeed, 70 per cent of today's reserves have been accumulated over this period.

Why have they done this and what are the consequences? Ronald McKinnon would argue that the state is pursuing a rational policy of fixing exchange rates, as a monetary anchor, while the balance of payments surpluses are simply the result of excess savings. But many emerging economies have intervened in currency markets on a huge scale, principally in order to keep export competitiveness and current account surpluses up (or current account deficits down). "Never again," said the emerging countries hit by crises in the 1980s and 1990s; "not even once," said China.

My difference with Ronald McKinnon are fundamentally two.

First, he believes that the real exchange rate is determined by the savings surplus, while I argue that the causality for the countries targeting the real exchange rate (and that is what they are, without doubt, doing) is the other way round. In other words, countries target a nominal exchange rate and try to keep inflation down. They do so by pursuing monetary, fiscal and regulatory policies intended to curb domestic demand and so make room for the surplus on net exports. I am not suggesting they can do this forever. But they can do it for a very long time.

The current account tail wags the economic dog – this being a mirror image of what I think has happened in the US over the past decade. It is, after all, US assets that the intervening countries have been targeting and so the US exchange rate that they have been holding up, the US current account deficit they have been financing and US longer-term interest rates that they have been keeping down. A trade deficit is contractionary: for any given level of domestic demand, it lowers domestic output. Thus, the US needed to expand domestic demand, in order to offset the contractionary effect of the external deficits. Some groups within the economy needed to spend more than their incomes. The most important such group turned out to be households. Thus the growth in US household indebtedness that led to today's "credit crunch" is a direct result not just of the global imbalances, in general, but of the exchange-rate targeting policies of a large number of emerging economies.

Second, I believe the principal motivations for the real exchange rate targeting are not to provide a monetary anchor, but to pursue export-led growth, accumulate reserves and, above all, minimise the risks historically associated with running sizeable current account deficits: this, in other words, is not so much "fear of floating" as "fear of deficits" and the financial crises they almost unfailingly brought.

What are the consequences of these policies? In a word, they are expansionary. The results normally include rapid rises in net exports, low interest rates, aimed at curbing the capital inflow, and expansion in the monetary base, despite attempts at sterilisation. The Chinese economy has been overheating as a direct result of this trio of effects.

Today's inflationary predicament

Today, the Federal Reserve is trying to re-expand demand in a post-bubble US economy. The principal impact of its monetary policy comes, however, via a weakening of the US dollar and an expansion of those overheating economies linked to it. To simplify, Ben Bernanke is running the monetary policy of the People's Bank of China. But the policy that is at least arguably appropriate to the US (I am not going into that debate before this audience) is wildly inappropriate for China and indeed

almost all the other countries tied together in the informal dollar zone or, as some economists call it, “Bretton Woods II”.

Thus, not only have the imbalances proved hugely destabilising in the past, but they are going to prove even more destabilising now that the US bubble has burst. When most emerging economies need much tighter monetary policy, they are forced to loosen still further. The result is strongly negative real interest rates in countries where they should clearly be positive.

What we see then is an incipient global inflation. Yet the central bank with the greatest influence on global monetary policy is the one confronting the post-bubble credit crunch. Its post-bubble predicament is made worse by the soaring energy prices that result from the strong growth of the world economy.

This then is a global challenge. The advanced countries are no longer the global driving force: they are importing inflation. If the world had a single central bank and a single currency, the former would surely tighten its monetary policy, in light of the evidence on the constraints on the rate of growth of potential global supply.

We do not have such a global central bank. The central bank that is closest to playing that role – the Federal Reserve – is responsible for about a quarter of the world economy. Its region is, of course, also the most economically depressed large one. It is as if the ECB were setting its monetary policy to meet the conditions of Spain alone. The results are likely to be highly inflationary.

What is to be done?

Let us go back to first principles.

First, the world as a whole cannot import inflation: if every central bank assumes that the rise in commodity prices is the product of policies made elsewhere, general overheating is likely to be the result. Worse, if that feeds into expectations the world will be depressingly similar to the 1970s. We are not there. Policymakers must ensure we never do get there.

Second, global monetary policy is too loose, despite the adverse impact of the credit crisis on high-income countries. In many emerging countries output is growing quickly, with inflation rising strongly. If, as seems likely, the world economy cannot grow as fast as people hoped only a year or two ago, emerging economies have to be part of the adjustment. This will become still more obvious when, at last, the high-income countries recover fully.

Third, the biggest monetary policy requirement is a tightening in emerging economies, many of which now have strongly negative real interest rates. A precondition for such a tightening is a relaxation of exchange rate targeting.

Fourth, if such relaxation of exchange-rate targeting is not going to happen, then the Federal Reserve has to take account of the global impact of its monetary policies, working, as they do, on the policies of the rest of the world's central banks. For this reason, at least, it is likely that Federal Reserve has already cut too far.

Conclusion

We have an incoherent global monetary system, with a quasi-global central bank concerned about just one region of the world economy and the monetary and financial consequences of current account imbalances created by exchange-rate targeting. I have argued here that both the financial crisis of today and the inflation are, at least in part, the consequence of this dysfunctional system. Change will, and must come. Let us hope it happens before we relive anything similar to the 1970s.

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[i] Robert Aliber and Charles Kindleberger, *Manias, Panics and Crashes* (Palgrave, 2005).