VIII. Conclusion: how might imbalances be fixed?

Last year was an exceptional one for the global economy. There was strong growth in most of the world, particularly the emerging market economies, yet still moderate inflation in spite of substantial increases in commodity prices. Financial institutions across the globe recorded excellent profits and prices in most financial markets rose substantially. Nevertheless, this exceptional performance was accompanied by a growing sense of unease that it might not last. One source of concern was that today's global economy increasingly seemed to exhibit similarities with that of the late 1960s – a disturbing thought, since it was during this period that the foundations were laid in the major industrial countries for the Great Inflation of the 1970s. In turn, this led to the debt crises of the 1980s which affected many emerging market economies.

Now, as in the late 1960s, real interest rates in the industrial countries have been low for an extended period and credit aggregates have been expanding rapidly. Similar to problems which emerged under the Bretton Woods system, there has also been downward pressure on the dollar related to the US external balance. This has, in recent years, led many other countries both to ease their monetary policies and to accumulate foreign exchange reserves in order to resist currency appreciation. The result has been a massive global expansion of liquidity. Fiscal policy has also been eased recently in many countries, recalling the joint impact of the Vietnam War and the Great Society programmes of that earlier era. Commodity prices, and oil prices in particular, have also moved up sharply and the effects are beginning to be seen further downstream, as well as in the external accounts of both consumers and producers.

Do these similarities mean that industrial countries are likely to experience a repeat of the high inflation and cyclical perturbations of the 1970s and 1980s? And that emerging markets face a recurrence of the debt problems of the 1980s? Simply put, the answer is: perhaps, but not necessarily. Perhaps, because forecasting is difficult and policy mistakes can by no means be ruled out. Not necessarily, because policymakers have clearly learned from their past errors. In the late 1960s and early 1970s, the costs of high inflation in the industrial countries were not well recognised. Nor was it adequately appreciated how quickly shifts in inflation expectations could lead to a vicious wage-price spiral. The success of central banks in reducing inflation, in spite of the costs involved in tackling it, gives credibility to central bankers when they say "never again". Moreover, policymakers worldwide have also learned something about coping with commodity price shocks. Those now confronted with higher-priced imports know that resisting adjustment through external borrowing, as was done in the 1970s, can eventually prove extremely costly. Those benefiting today from higher prices remember how easily they became overextended by borrowing against the collateral that higher prices provided.

It is now obvious, sadly only with hindsight, that commodity prices are no different from the prices of houses and financial assets. All of these prices can fall as well as rise, but the nominal value of debts stays fixed throughout.

We can take solace from these lessons learned from the past. Nevertheless, we must also be aware of the dangers of fighting the last war all over again. As noted in the Introduction to this Annual Report, the world has changed in three fundamental and welcome ways since the 1960s. By suggesting a non-inflationary outcome, these structural changes further support the conclusion "perhaps, but not necessarily".

First, the liberalisation and globalisation of the real economy have massively boosted supply potential, substantially changed relative prices, and given a downward tilt to inflation as demand has lagged behind. Second, a combination of deregulation and technological progress has had profound effects on financial systems. They are increasingly market- rather than bank-based, global in scope, and populated by ever larger and more complex firms whose activities span many sectors. And third, there has been a shift in the monetary regime towards the overriding objective of keeping inflation low. These individual changes, and perhaps more importantly their interactions, point to new lessons as well as new uncertainties.

One lesson is based on the interaction of ongoing positive supply shocks and the new monetary regime. This implies that deflationary pressures may, in the future, be almost as frequently observed as inflationary pressures. It also raises the question of whether the source of the deflation ought not to condition the policy response. Just as first-round price increases associated with negative supply shocks are now commonly tolerated by policymakers, why should the same not hold true for positive supply shocks? Another lesson can be drawn from the interaction of positive supply shocks and the behaviour of the financial system. These shocks can more easily generate optimism in the system, and create a perception that investment risks are lower than they really are. As a result, the supply of credit and debt becomes inherently more elastic. A third lesson relates to the interaction of the modern financial system and the pursuit of price stability. Reactions within the financial system to policy tightening are becoming an ever more significant part of the transmission mechanism and must increasingly condition the pace of tightening.

A final, and perhaps most important, lesson arises from the interaction of all three systemic changes. If positive supply shocks push down inflation, such that policymakers have no reason to tighten credit conditions, then the greater capacity of financial systems to supply credit and debt will be matched by greater demand. Such circumstances could create a boom and bust cycle in the financial system which would, in turn, generate headwinds that could feed back and weaken the real economy in various ways. And if the starting point for this process were already low inflation, the outcome might be an unwelcome disinflationary process that would be more malign than one generated by positive supply shocks alone.

These observations do not demand a radical reorientation of policy. Rather, they only suggest further steps down a path already chosen. Public policies have already assumed a more medium- to long-term orientation. On the supply side, this is evident in the increased emphasis on structural reforms in recent years. In particular, the need for measures to promote financial stability has been widely accepted. On the demand side, recall that in the 1960s both monetary and fiscal policies were "fine-tuned" to stabilise the business cycle and reduce unemployment. Subsequently, recognition of the costly longer-term effects of such policies led to monetary targeting, inflation targeting and suggestions for longer-term frameworks for fiscal policies as well.

Without fundamentally altering these longer-term frameworks, policymakers should now consider how they might be adapted to take account of a further complication. The build-up of debt levels over time, both domestically and internationally, can eventually also lead to economic problems with attendant and often substantial costs. Consider how long it took for Japan and East Asia to recover from their respective financial crises. Recent policy actions by a number of central banks, partly in response to credit-fuelled increases in house prices, indicate a growing recognition of this problem. True, formalising a policy response will be difficult since there is no clear benchmark to indicate when credit growth, debt levels or asset prices are "too high". Nevertheless, the stakes are certainly such as to warrant a significant analytical effort in this regard.

This Conclusion addresses two issues. First, it examines current risks to the global economic outlook, in particular the implications of internal and external imbalances, and the policies that might help reduce those risks. Second, it considers whether we need longer-term frameworks that might help avoid the build-up of financial imbalances in the first place. At the domestic level, the question is whether it is worth implementing a macrofinancial stability framework. At the international level, the question is whether improvements to the international monetary system are required to complement the simple pursuit of national self-interest.

Do current exposures warrant a policy response?

While it would be very difficult to get people to agree that the global economy has imminent "problems", there is more of a consensus that it has certain "exposures". One simply cannot ignore the number of indicators that are now simultaneously exhibiting marked deviations from historical norms. Among the internal imbalances that compel attention, real policy rates in many industrial countries and in emerging Asia continue to hover around zero. Nominal rates on long bonds, as well as credit spreads and measures of market volatility, are remarkably low. The household saving rate in many industrial countries has been trending sharply downwards, and debt levels are at record highs. House prices in many countries have never been higher. And in China, the investment ratio has risen to a startling 50% of GDP. Finally, external imbalances have never been larger in the postwar period. Any or all of these numbers might well revert to the mean, with associated implications for global economic growth. Such an unwinding might be gradual, and possibly benign, but it could also be rapid and disruptive. In large part, what happens will be determined by real-financial interactions that we should not pretend to fully understand.

What can policy do about these internal and external imbalances? With respect to internal imbalances, one obvious answer is to increase interest rates to induce reductions in long-term exposures. But this immediately raises the prospect of conflict with more traditional short-term objectives of policy, namely low unemployment and the avoidance of excessive disinflation. As for external imbalances, here too many conflicts arise. For example, fiscal tightening might help remedy external imbalance problems for deficit countries, but could also lead to uncomfortable levels of unemployment. In such circumstances, perhaps the best that can be hoped for is "opportunistic" progress. That is, look for opportunities to cut these longer-term exposures, but only as other priorities allow.

In the United States, against the background of an expanding economy, monetary policy has already begun to tighten in a measured way. While this has been primarily a response to rising capacity utilisation rates and concerns about future inflation, the influence of higher rates in reducing internal imbalances is a welcome by-product. The US economy has arguably become overdependent on consumer spending, borrowing and the extraction of equity from housing wealth. This is particularly so because, in aggregate, an increase in house prices does not boost national wealth in the same way as investment based on saving from income and increases in productivity. Owners gain from higher house prices, but everyone must now pay higher prices for housing services. From this perspective, the US economy is significantly more exposed than it might appear.

Even given the currently robust state of the US economy, however, this tightening will have to be conducted with some delicacy. One uncertainty surrounds the heightened role in the transmission mechanism likely to be played by asset prices, especially house prices. Some indication of this might be given by the experience of the United Kingdom and Australia. There, as in the Netherlands a few years ago, house prices have begun to stabilise under the influence of higher policy rates, and the growth of consumer spending has already begun to slow. A further complication has been the possibility that higher policy rates might also restrain corporate investment. Fortunately, corporations have been quite successful in reducing their debt burden in recent years and have both high profits and high liquidity. Yet it must also be said that the recent rebound in investment remains far less robust than that seen in earlier cycles.

Another concern has been that tightening might lead to disruption in financial markets, if positions taken on in the "search for yield" were suddenly reversed. This has not happened to date, probably reflecting the clear communication by the Federal Reserve of its future intentions. Nevertheless, uncertainties remain. Should inflationary pressures prove stronger than currently anticipated, policy rates might have to rise more rapidly. This could still surprise market participants. Another possibility is that assumptions about the Federal Reserve's future intentions, albeit stated in a conditional way, might have led some speculators to respond to the narrowing of carry trade margins by further leveraging their positions to maintain rates of return. This would imply that further unwinding, perhaps significant, might still be to come.

In a number of other major economies, returning interest rates to more normal levels would involve even greater conflicts. In continental Europe and Japan, continued subdued economic growth provides no support for higher rates. In Japan, the failure to break definitively out of deflation also militates against such action, while in Europe the disinflationary effects of the increase in the value of the euro point in the same direction. In any event, it bears noting that private sector debt exposures in Japan continue to fall, not rise, while exposures in continental Europe have not risen as fast, nor been as widespread, as those in the United States. That said, the ECB has repeatedly expressed its disquiet regarding the rate of expansion of monetary and credit aggregates and the sharp increases in house prices in many parts of the euro area.

Raising policy rates elsewhere in Asia might be easier. Inflationary pressures have been somewhat more in evidence, and growth has been rapid. Moreover, concerns have been expressed about both rising property prices in a number of countries and the increasing reliance of banks on consumer lending. Higher rates in the United States also imply that tightening in Asia would have less of an impact on the region's exchange rates against the dollar. Nevertheless, in spite of recent healthy growth, many in Asia still worry about its robustness and the capacity of the corporate and banking sectors to handle higher rates. In China, rates were allowed to rise only slightly last year, given the desire to encourage greater consumer spending and to avoid more capital inflows. While there was evident overheating with respect to fixed capital investment, the Chinese authorities are likely to continue to try to deal with it through administrative means. Unfortunately, it is not clear whether such measures will work. As in the United States, the concern in Asia must then be that an inadequate degree of monetary tightening will lead to either inflation or growing internal imbalances, or both.

Turning to external imbalances, the widening current account deficit of the United States is a serious longer-term problem. That is, it could eventually lead to a disorderly decline of the dollar, associated turmoil in other financial markets, and even recession. Equally of concern, and perhaps closer at hand, it could lead to a resurgence of protectionist pressure. The unprecedented size of the deficit, the speed with which external debts are growing, the increasing reliance on the official sector for deficit financing, and the fact that US borrowing has primarily financed consumption (rather than investment) all suggest an eventual problem. Moreover, given the interdependency of modern financial markets, it is likely that problems would not be confined to the dollar alone. A higher risk premium on US dollar-denominated assets could raise long rates and spreads, with implications for asset prices of all kinds.

Yet to say such an outcome must be imminent would be wrong. While its net external debt has been growing for years, the United States still earns more on its assets abroad than it pays out to foreigners. Moreover, since the debts of US nationals are denominated almost exclusively in dollars, and the assets are in foreign currency, declines in the dollar automatically cut the recorded net debt significantly. And foreign officials who support the US dollar through intervention have many valid reasons to continue to do so. There should therefore be time for policies designed to reduce existing exposures to have their desired effect. However, time might well be running out.

What could policy do at this juncture? The textbook answer, against the backdrop of declining levels of excess capacity, is that deficit countries should reduce the rate of growth of domestic spending below that of domestic production. Allowing their currencies to depreciate in real terms would make their products more competitive, and also provide an incentive for production to shift out of non-tradables into tradables. The opposite should occur in surplus countries: that is, higher real exchange rates and more domestic spending. However, it is also important to set these prescriptions for macroeconomic and structural policies against the constraints and trade-offs that apply in the real world.

The United States probably faces the least conflict in its macroeconomic policy settings. Concerns about potential inflation, internal imbalances and the external deficit all call for restraint in domestic spending. Given the size of the government deficit, the obvious first step would be to cut expenditures and raise taxes. While the administration has set a deficit reduction objective, the specific policies required to implement this remain to be put in place. That is a pity, since, without early fiscal action, the burden will fall more heavily on tighter monetary policy. While higher interest rates would help reverse the decade-long slide in household saving – the real key to reducing the external deficit – a disproportionate reliance on monetary policy raises the risk of all the disruptive transitional problems discussed above.

The surplus countries of continental Europe and Asia face deeper conflicts as they contemplate the use of macroeconomic instruments to encourage domestic demand. In both regions, though arguably more reasonably in the latter, concerns remain about fostering inflationary pressures stemming from higher commodity prices. Moreover, there also seems to be a clash between short-term exigencies and longer-term considerations. For example, in Europe the use of fiscal policy immediately runs foul of high debt levels, demographic pressures and the Stability and Growth Pact. In effect, Europe used up its fiscal room for manoeuvre some years ago. In Asia, with Japan an obvious exception, the overt fiscal positions generally seem healthier. Yet in many of these countries, and certainly in China, concerns about the ultimate costs to the taxpayer of restructuring financial systems are a further constraint that cannot be prudently ignored. As for easier monetary policies, in addition to lingering concerns about inflation, this recommendation is in direct conflict with the general tightening needed to reduce the longer-run internal imbalances described above. Conflicts of this nature explain why, for the first time in decades, central bank watchers in some countries are even disputing the direction of policy moves rather than their timing and magnitude.

Exchange rate changes also cut several ways. So far, the dollar has declined in an orderly manner, but mostly against currencies that are truly free-floating. The upshot is that the dollar, in real effective terms, is no lower now than its average of the last 30 years. Given how little the US trade deficit seems to have been affected to date by dollar depreciation, in part because of the limited impact on domestic prices, some further movement seems almost inevitable. Obvious candidates for revaluation would be the Chinese renminbi and other Asian currencies that take their cue from it. While the Chinese authorities have legitimate reasons for concern about revaluation – the health of the financial system and the income stream of domestic farmers – these concerns would be better dealt with through domestic policies. In addition, greater exchange rate flexibility would help curb the massive capital inflows that are contributing to the growing internal imbalances that threaten the sustainability of China's long expansion. Moreover, increased exchange rate flexibility would give more scope for monetary policy to resist domestic inflation.

Changes in real exchange rates provide an incentive for resources to shift appropriately between the tradable and non-tradable sectors. Constraints that impede such a shift should be removed. Regardless of the trade situation, structural changes in appreciating countries would also be in their domestic interests. In Japan, the principal requirements are the freeing of service industries from stifling regulation that squeezes profits, and an increased willingness to close down insolvent companies in the traded goods sector. Continental Europe presents perhaps the biggest adjustment challenge since the prices of many services are constrained by regulation, relative wages are inflexible, and non-wage labour costs are high. These impediments should be removed. In China, the share of services in GDP is around 30%. Given that the comparable figure in Brazil is around 50%, it is clear that the legacy of central planning needs to be further swept away to encourage the production of non-tradables.

Finally, the United States has a particularly flexible domestic production structure, but it also has a lot of adjustment to undertake. Rejuvenating the manufacturing sector will not be easy, given that it has shrunk to only 10% of GDP, and that profits in manufacturing remain lacklustre. The fact that the traded goods sector has, so far, hardly shared in the recent upturn of investment in the United States is also a discouraging sign. Perhaps the greatest impediment to an expansion in the production of traded goods and services in the United States is the perceived competitive threat arising from China, India and other emerging market countries. It must be admitted that this is not a propitious moment to be seeking to regain international market share.

If what needs to be done to resolve external imbalances is reasonably clear, it also seems clear that much of it is simply not going to happen in the near term. One reason for this is domestic policy conflicts of the sort noted above. Indeed, even such policies as a reduction in the US fiscal deficit, desirable for both domestic and international reasons, could easily fall prey to political wrangling and entrenched interests. Worse, policymakers who blame the policies of others for causing external imbalances, while denying their own culpability, risk destabilising financial markets in the meantime and exacerbating the problems that policymakers should be seeking to resolve. But there are broader reasons as well. Not enough attention is being paid to systemic issues, nor is there adequate recognition of the possibility that acting in self-interest may be far from optimal. What is needed now is a real dialogue among all those affected by these external imbalances. Everyone needs to commit to some unpleasant compromises now, in order to avoid even more unpleasant alternatives in the future.

Longer-term frameworks for macrofinancial stability

It is one thing to deal with problems as they arise. It is quite another to design frameworks to prevent them occurring in the first place. The fundamental changes to the global economic, financial and monetary system identified in the Introduction to this Annual Report have clearly brought many economic benefits. The policy challenge is to reconcile these secular gains in economic "efficiency" with the steps that might be taken to reduce the costs of periodic disruptions resulting from the interaction of these changes.

Towards a domestic macrofinancial stabilisation framework?

A guiding principle, should one wish to introduce a macrofinancial stabilisation framework, would be that both regulatory and monetary policies should be applied more symmetrically over the cycle. This suggestion parallels prescriptions for fiscal policy that emphasise running surpluses in upswings to "preserve some room for manoeuvre". In the case of regulatory policy, more symmetry would imply that more capital should be built up in good times. Not only would this help restrain credit excesses, but it would also allow capital to be run down in bad times, up to a point, to cushion the economy from associated credit constraints. Tightening monetary policy in the face of excessive credit growth would also attenuate the worst excesses, and could obviate the need for radical easing later that might result in policy rates facing the constraint of the zero lower bound. This would be of considerable advantage should an unwelcome degree of disinflation emerge in such an environment.

In practice, a more symmetrical regulatory policy might be implemented in various ways. Were the regulators to be convinced that systemic risks were rising to dangerous levels, they could have recourse to discretionary action. Liquidity ratios, loan-to-value ratios, collateral requirements, margin requirements and repayment periods could all be tightened. Indeed, such actions were commonly used by central banks in industrial countries a number of years ago, and have been used to good effect more recently in Hong Kong SAR and elsewhere. In contrast, were the authorities to be less certain about their capacity to predict stressful events, they might rely more on some simple indicators to encourage more prudent behaviour. Prudential norms pertaining to the rate of growth of credit or asset prices could in principle be used to influence the pricing of risk, provisions for losses (for expected losses) or the accumulation of capital (for unexpected losses). In Spain, a system of "dynamic provisioning for loan losses" has already been introduced: provisions must now rise with loan levels on the assumption that losses in the future will be similar to those experienced in the past, measured over the full economic cycle.

Regarding a more symmetrical monetary policy, this too might rely on either discretion or simple normative indicators. As to the former, both the Bank of England and the Reserve Bank of Australia have, in the last year, indicated that concerns about rising house prices and debt played a role, along with strong demand growth, in explaining their respective interest rate increases. Sveriges Riksbank, for similar reasons, did not lower interest rates as much as might have been expected given that it was actually undershooting its inflation target. As for the use of normative indicators, the two-pillar approach of the ECB could be noted. However, the suggestion here would be somewhat different: namely, to use monetary and credit data as a basis for resisting financial excesses in general, rather than inflationary pressures in particular.

Identifying when financial imbalances are building up, to a point likely to involve substantial macroeconomic costs, is a serious practical problem. Yet a macrofinancial orientation should at least ensure that policymakers are looking in the right direction. Those concerned with weaknesses in the financial sector would thus focus more carefully on areas where stresses were more likely to have knock-on effects elsewhere. One implication is that banks, as providers of liquidity, should rightly receive more attention than some other institutions, and that bigger institutions need closer monitoring than small ones. Indeed, to reflect these externalities, prudential standards for such institutions might justifiably be tougher, all else equal. Another implication, given the growing importance of markets for both providing financing and transferring risks, is that market monitoring and the evaluation of structural developments would have to be further enhanced. Finally, because payment and settlement systems are by definition systemic, monitoring how effectively they function would take on even greater importance.

Moreover, quantitative identification of systemic imbalances has also been improving. With respect to data, the IMF has suggested a list of Financial Soundness Indicators for individual countries, and is now experimenting with their use in conducting its Financial Sector Assessment Program. With regard to monitoring, many central banks are now beginning to evaluate the soundness of their own financial sectors, as well as vulnerabilities arising from the financial condition of the corporate and household sectors. Increasingly, the results are being published in financial stability reviews. Moreover, in recent years there has been a clear improvement in the capacity to make judgments about the risks of banking and currency crises using quantitative models. Measures of internal and external imbalances, generally defined as substantial and sustained deviations of financial variables from previously established norms, do seem to have some predictive power.

At the same time, while progress has been made in strengthening our assessment powers, significant shortcomings remain. Improvements in financial intermediation make higher debt/income ratios more sustainable than in the past, complicating the quantitative assessment of just when these ratios become excessive. In addition, some basic data tend to be flawed. External ratings, internal ratings and market-based measures of credit risk are all likely, at times, to be affected by waves of optimism or pessimism. They may then give misleading indications of the dangers faced by individual components of the system looking forward. Moreover, the use of aggregated data for prediction purposes fails to capture interactions that can be both complex and non-linear.

We need to know more about the distribution of risks within the system, as well as the likelihood that different market participants might react to similar shocks in the same way. In effect, we need better means to stress-test the financial system as a whole, as well as to test the manner in which stresses might then feed back on the real economy, leading in turn to another set of shocks to the financial system and so on. None of this will be easy.

How might policymakers react, assuming that there was agreement among the relevant agencies that an imbalance problem was emerging? The likely first step would be orchestrated statements of concern. The threat of a policy response might induce both creditors and debtors to review their investment strategies. Should it then be deemed necessary to act, in a discretionary way, recourse to prudential regulation might come first if it were thought that the health of the financial system was in any way being impaired. Here, an important new insight for the regulators, based on concerns about the functioning of the system as a whole, is that they would have to give due emphasis to the problem of "fallacy of composition". What might be an appropriate recommendation for a single institution might not necessarily make sense for the system as a whole. Conversely, monetary policy might be used first if concerns related primarily to the growing exposures of debtors, while the financial system itself was still thought to be in a good state of health.

As to institutional arrangements, the most important problem to emerge from the separation of regulatory supervision and central banking is that macrofinancial stability issues could fall between the cracks. That is, the agencies involved see problems building up, but assume that somebody else will do whatever needs to be done. One way to avoid this would be to have senior representatives of central banks, regulatory agencies and treasuries come together regularly to monitor events and identify problems. Interestingly, such an arrangement already exists at the international level, in the form of the Financial Stability Forum, but there is no domestic counterpart in many countries. In countries where similar inter-agency groupings have been set up to facilitate crisis management and resolution, the simplest approach would be to widen their mandate to encompass crisis prevention as well.

What would be the practical impediments to implementing such a framework, and could they be removed? Perhaps the most important impediment would be a simple lack of conviction that internal imbalances were likely to raise risks for either the economy or the financial system, allied with a doubt that they could ever be identified in advance – in sum, a new framework would be neither needed nor workable. Yet the first of these arguments could be turned on its head given acceptance of a minimax optimising strategy that put greater weight on avoiding "truly bad outcomes" in an environment of great uncertainty. In effect, the burden of justification would then fall on those willing to accept the longer-term risks attendant on policies that deviated sharply from historical norms. And the identification issue would clearly benefit from more research on what seems, unfortunately, to be a steadily expanding historical data set of financial crises.

What specific impediments would prevent regulators from operating as the new framework would suggest? One problem is that, after decades of focusing on individual institutions, some might not share the belief that financial instability can emerge even if individual institutions seem healthy. A second is that they generally do not have the powers ascribed to them above. Concerning the former, the culture of regulators has already changed dramatically, and could change further given more regular interaction with other parties involved with these systemic questions. And as to the latter, powers could be obtained if legislators became convinced of the desirability of granting them. While this might seem unlikely, recall that during the 1960s and 1970s there was very little public support for fighting inflation. Yet today, the desirability of such policies is almost universally acknowledged.

What are the specific impediments that would prevent central bankers from operating as the new framework would suggest? The first and most important one is that it could be seen to conflict with the desire to stabilise inflation at a low positive level, as would be the case if inflation were under control but the new framework suggested that policy should be tightened. Perhaps the first question to ask is whether maintaining low positive inflation really is desirable in the face of ongoing positive supply shocks. This analytical issue was debated vigorously in the interwar period and deserves to be readdressed. But even assuming this objective is maintained, it would not seem so difficult to adapt current inflation-oriented regimes to reflect concerns about internal financial imbalances. Leaning against financial excesses, at initially low inflation levels, is equivalent to leaning against deflation over the longer horizon needed for the excesses to unwind. In practice, a central bank might normally conduct policy as it does today. However, it would also make clear, through its public monitoring of financial vulnerability indicators, that policy would occasionally have to be conducted in a way that reflected these longer-term concerns about price stability.

Towards an international macrofinancial stabilisation framework?

In a sense, it is odd that domestic financial imbalances are not higher on policymakers' list of priorities since international imbalances have been a source of concern for centuries. Indeed, earlier versions of the international monetary system were all designed to prevent such imbalances from getting dangerously out of hand. For example, the gold standard incorporated a process (not always smooth) of automatic adjustment of trade imbalances. Against the backdrop of the so-called "impossible trinity", countries retained a fixed exchange rate and free capital flows but had to give up monetary independence in the interests of systemic discipline. Under the Bretton Woods system, they kept fixed exchange rates and independent monetary policies but gave up free capital flows. The IMF essentially played the role of referee, disciplining in particular countries running large external deficits. Subsequently, after increasingly free capital flows brought an end to the Bretton Woods system, floating exchange rates were assumed to be the mechanism through which trade imbalances would be reduced before they attained disorderly proportions. Given the size of recent current account imbalances, dominated by the current account deficit of the United States, this last supposition is being increasingly challenged. As noted above, the principal concerns are that a sharp decline in the demand for dollar-denominated assets might generate instability in global financial markets, or that protectionist pressures might multiply.

This raises the question of which characteristics of the current international monetary and financial system have contributed to this outcome, and how they might be changed to avoid future problems. The underlying issue seems to be that we no longer have a system that somehow forces countries to alter their relative degrees of domestic absorption, and associated exchange rates, so as to reduce external imbalances in an orderly way. A number of important creditor countries, particularly in Asia, have taken significant steps to hold down the value of their currencies against the dollar, thus impeding the needed downward adjustment of the dollar in effective terms. In sum, we do not really have a floating rate system. But, by the same token, we are far removed from the Bretton Woods system as well. IMF adjustment principles have never held much sway over creditor countries, and this is arguably even more the case today. While it is logically possible that policy measures consistent with resolving domestic imbalances in both creditor and debtor countries might resolve external imbalances as well, this should not be assumed. In any event, it is not likely to happen. This leads on to the question of whether there are institutional changes that might be recommended to strengthen the international adjustment process. Three possibilities might be considered.

First, one might contemplate going back to a more rule-based system. Several academics have suggested the establishment of a single international currency. In the context of the impossible trinity, this would imply national authorities relinquishing domestic monetary control and moving away from still existing capital controls. A more realistic recommendation might be to have a small number of more formal currency blocs (say, based on the dollar, euro and renminbi/yen), but clearly they would have to float more freely against each other. Nor would such a system avoid the possibility of excessive capital flows, based on misguided optimism about one currency bloc or another, leading to disruptive exchange rate changes and associated international resource misallocations. At the practical level, Asian economies seem to be establishing more formal contacts and procedures for regional monetary cooperation. However, they are still far from anything like the exchange rate arrangement which preceded the euro, much less a single currency.

A second possibility could be to revert to a system more like that of Bretton Woods. History teaches that this would only work smoothly if there were more controls on capital flows than is currently the case, which would entail its own costs. Moreover, the IMF would have to be given substantially more power to force both creditors and debtors to play their role in the international adjustment process. This might, in turn, reduce the incentives for countries to build up massive reserve holdings as a form of self-insurance. Needless to say, persuading countries, particularly large ones, to voluntarily give up sovereignty in this fashion would not be easy.

Third, and most promising in the real world, consideration could be given to informal cooperative solutions, recognising interdependencies and the need to avoid circumstances that could lead to systemic disruptions. At the very least, this would require large creditor countries to share views with debtors on an ongoing basis as to whether problems were emerging and, if so, what policies might help resolve them. In the framework of the impossible trinity, this would imply that, at various times, national policymakers would have to agree to constraints on certain aspects of their behaviour. However, similar to dealing with internal imbalances, the impediments to action arising from different perceptions of systemic risk, different cultures and analytical models, and simple national interest ("turf wars") should not be underestimated.

To sum up, all policy choices involve trade-offs and judgment, and policy in the area of macrofinancial stability is no exception. On the one hand, the more stable macroeconomic environment we have experienced over the last 20 years and the policy framework that has nurtured it have yielded unquestionable benefits. On the other hand, evidence of emerging strains is not difficult to find and future problems cannot be ruled out. What is being suggested here is that financial imbalances, both domestic and international, need more systematic attention, and that this might be accomplished through an evolutionary adaptation of the current policy framework. While there are clearly impediments to this happening, those who believe that there is a problem that needs fixing would not consider them insuperable.