

Ben S Bernanke: Global imbalances – links to economic and financial stability

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the Banque de France Financial Stability Review Launch Event, Paris, 18 February 2011.

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By facilitating the allocation of the world's savings to the most productive uses, the free flow of capital across national borders confers substantial economic benefits, including the promotion of economic growth. That said, we have seen a number of episodes in which international capital flows have brought with them challenges for macroeconomic adjustment, financial stability, or both. Such challenges have tended to arise in two situations: first, when the "rules of the game" of the international monetary system – the policy responses that countries are expected to take to help foster a balanced global economy over time – are either poorly articulated or not observed by key countries; and second, when the financial systems of nations receiving strong capital inflows have not been up to the task of investing those inflows productively.

These issues are hardly new. In the late 1920s and early 1930s, the U.S. dollar and French franc were undervalued, with the result that both countries experienced current account surpluses and strong capital inflows. Under the unwritten but long-standing rules of the gold standard, those two countries would have been expected to allow the inflows to feed through to domestic money supplies and prices, leading to real appreciations of their currencies and, with time, to a narrowing of their external surpluses. Instead, the two nations sterilized the effects of these capital inflows on their money supplies, so that their currencies remained persistently undervalued. Under the constraints imposed by the gold standard, these policies in turn increased deflationary pressures and banking-sector strains in deficit countries such as Germany, which were losing gold and foreign deposits. Ultimately, the unwillingness of the United States and France to conduct their domestic policies by the rules of the game, together with structural vulnerabilities in financial systems and in the gold standard itself, helped destabilize the global economic and financial system and bring on the Great Depression.

The Asian financial crisis of the late 1990s illustrates a somewhat different type of risk associated with large cross-border flows of capital. During the 1990s, strong capital inflows helped support robust growth in many Asian economies. But Thailand's devaluation in mid-1997 triggered closer scrutiny of developments in the region. Investors began to recognize that the financial systems of some Asian economies – because of institutional weaknesses, inadequate regulation, or other deficiencies – had not effectively channeled the surge of incoming funds into productive investments. As foreign investors lost confidence, capital flows into the region reversed sharply, and the credit-driven boom came to a precipitous end. The Asian crisis imposed heavy costs in terms of financial and macroeconomic instability in the affected countries. In this case, capital inflows posed a problem because of weaknesses in the financial systems and regulatory oversight in countries receiving foreign capital.

Although these issues are now generally discussed in the context of emerging market economies, the United States – the recipient of the largest capital inflows in the world – has also faced challenges coping with capital inflows. Notably, the failures of the U.S. financial system in allocating strong flows of capital, both domestic and foreign, helped precipitate the recent financial crisis and global recession.

Why was the United States, a mature economy, the recipient of net capital inflows that rose to as much as 6 percent of its gross domestic product prior to the financial crisis? A significant portion of these capital inflows reflected a broader phenomenon that, in the past, I

have dubbed the global saving glut.¹ Over the past 15 years or so, for reasons on which I have elaborated in earlier remarks, many emerging market economies have run large, sustained current account surpluses and thus have become exporters of capital to the advanced economies, especially the United States. These inflows exacerbated the U.S. current account deficit and were also a factor pushing U.S. and global longer-term interest rates below levels suggested by expected short-term rates and other macroeconomic fundamentals.

My earlier comments on the global saving glut hypothesis focused on the sources of the capital inflows to the United States and their effects on global longer-term interest rates and the U.S. current account, without attention to the composition of those flows. My paper for the Banque de France *Financial Stability Review* extends the basic global saving glut hypothesis to consider the portfolio preferences of foreign investors in the United States and the implications of those preferences.² Several researchers have argued that capital flows from emerging markets to advanced economies will tend to be directed to the safest and most liquid assets, of which, these researchers argue, there is a relative shortage in emerging markets.³ My paper confirms empirically that the global saving glut countries – principally, some emerging Asian economies and Middle Eastern oil exporters – did indeed evince a strong preference for very safe and liquid U.S. assets in the middle of the past decade, especially Treasury and agency securities.

Although a large share of the net capital inflows to the United States came from emerging markets, substantial gross capital inflows were received from the advanced economies as well. An additional contribution of the paper is to examine the portfolio preferences of these advanced economy, especially European, investors. The paper finds that, like the global saving glut countries, European investors placed a high value on safety and liquidity in their U.S. investments; however, relative to purchases by emerging markets, those of European investors encompassed a broader range of U.S. securities, including sizable amounts of private-label mortgage-backed securities (MBS) as well as other highly rated asset-backed securities. Unlike the global saving glut countries, which funded their acquisitions of U.S. assets through their current account surpluses, Europe on net had a roughly balanced current account and thus issued liabilities to fund acquisitions of U.S. assets. However, as these liabilities were tilted toward more traditional securities, including sovereign debt, as well as bank deposits, the result here too was a net increase in the global demand for highly rated U.S. assets.

The preferences of foreign investors for highly rated U.S. assets, together with similar preferences by many domestic investors, had a number of implications, including for the relative yields on such assets. Importantly, though, the preference by so many investors for perceived safety created strong incentives for U.S. financial engineers to develop investment products that “transformed” risky loans into highly rated securities. Remarkably, even though a large share of new U.S. mortgages during the housing boom were of weak credit quality, financial engineering resulted in the overwhelming share of private-label mortgage-related

¹ See Ben S. Bernanke (2005), “The Global Saving Glut and the U.S. Current Account Deficit,” speech delivered at the Sandridge Lecture, Virginia Association of Economists, Richmond, Va., March 10; and Ben S. Bernanke (2007), “Global Imbalances: Recent Developments and Prospects,” speech delivered at the Bundesbank Lecture, Berlin, Germany, September 11.

² See Ben S. Bernanke, Carol Bertaut, Laurie Pounder DeMarco, and Steven Kamin (2011), “International Capital Flows and the Returns to Safe Assets in the United States, 2003–2007,” Banque de France *Financial Stability Review*, no. 15 (February), pp.13–26.

³ See, for example, Ricardo J. Caballero, Emmanuel Farhi, and Pierre-Olivier Gourinchas (2008), “An Equilibrium Model of ‘Global Imbalances’ and Low Interest Rates,” *American Economic Review*, vol. 98 (1), pp. 358–93; and Ricardo J. Caballero and Arvind Krishnamurthy (2009), “Global Imbalances and Financial Fragility,” *American Economic Review: Papers & Proceedings*, vol. 99 (May), pp. 584–88.

securities being rated AAA. The underlying contradiction was, of course, ultimately exposed, at great cost to financial stability and the global economy.

To be clear, these findings are not to be read as assigning responsibility for the breakdown in U.S. financial intermediation to factors outside the United States. Instead, in analogy to the Asian crisis, the primary cause of the breakdown was the poor performance of the financial system and financial regulation in the country receiving the capital inflows, not the inflows themselves. In the case of the United States, sources of poor performance included misaligned incentives in mortgage origination, underwriting, and securitization; risk-management deficiencies among financial institutions; conflicts of interest at credit rating agencies; weaknesses in the capitalization and incentive structures of the government-sponsored enterprises; gaps and weaknesses in the financial regulatory structure; and supervisory failures.⁴ In reflecting on this experience, I have gained increased appreciation for the challenges faced by policymakers in emerging market economies who have had to manage large and sometimes volatile capital inflows for the past several decades.

The global financial crisis is receding, but capital flows are once again posing some notable challenges for international macroeconomic and financial stability. These capital flows reflect in part the continued two-speed nature of the global recovery, as economic growth in the emerging markets is far outstripping growth in the advanced economies.⁵

In light of the relatively muted recoveries to date in the advanced economies, the central banks of those economies have generally continued accommodative monetary policies. Some observers, while acknowledging that an aborted recovery in the advanced economies would be highly detrimental to the emerging market economies, have nevertheless argued that these monetary policies are generating negative spillovers. In particular, concerns have centered on the strength of private capital flows to many emerging market economies, which, depending on their policy responses, could put upward pressure on their currencies, boost their inflation rates, or lead to asset price bubbles.

Although policymakers in the emerging markets clearly face important challenges, such concerns should be put into perspective. First, these capital flows have been driven by many factors, including expectations of more-rapid growth and thus higher investment returns in the emerging market economies than in the advanced economies. Indeed, recent data suggest that the aggregate flows to emerging markets are not out of line with longer-term trends. Second, as I noted earlier, emerging market economies have a strong interest in a continued economic recovery in the advanced economies, which accommodative monetary policies in the advanced economies are intended to promote. Third, policymakers in the emerging markets have a range of powerful – although admittedly imperfect – tools that they can use to manage their economies and prevent overheating, including exchange rate adjustment, monetary and fiscal policies, and macroprudential measures. Finally, it should be borne in mind that spillovers can go both ways. For example, resurgent demand in the emerging markets has contributed significantly to the sharp recent run-up in global commodity prices. More generally, the maintenance of undervalued currencies by some countries has contributed to a pattern of global spending that is unbalanced and unsustainable. Such imbalances include those not only between emerging markets and advanced economies, but also among the emerging market economies themselves, as those countries that have allowed their exchange rates to be determined primarily by market forces

⁴ For a discussion, see Ben S. Bernanke (2010), “Causes of the Recent Financial and Economic Crisis,” statement before the Financial Crisis Inquiry Commission, September 2.

⁵ For a discussion of the international implications of the two-speed recovery, see Ben S. Bernanke (2010), “Rebalancing the Global Recovery,” speech delivered at the Sixth European Central Banking Conference, Frankfurt, Germany, November 19.

have seen their competitiveness erode relative to countries that have intervened more aggressively in foreign exchange markets.

Our collective challenge is to reshape the international monetary system to foster strong, sustainable growth and improve economic outcomes for all nations. Working together, we need to clarify and strengthen the rules of the game, with an eye toward creating an international system that more effectively supports the simultaneous pursuit of internal and external balance. To achieve a more balanced international system over time, countries with excessive and unsustainable trade surpluses will need to allow their exchange rates to better reflect market fundamentals and increase their efforts to substitute domestic demand for exports. At the same time, countries with large, persistent trade deficits must find ways to increase national saving, including putting fiscal policies on a more sustainable trajectory. In addition, to bolster our individual and collective ability to manage and productively invest capital inflows, we must continue to increase the efficiency, transparency, and resiliency of our national financial systems and to strengthen financial regulation and oversight.

None of these changes will be easy or immediate. To help us achieve them, we must continue to strengthen our mechanisms for international cooperation, including in the Basel Committee, the Financial Stability Board, and the Group of Twenty Mutual Assessment Process, and work together to enhance surveillance by the International Monetary Fund.

I am pleased that our French hosts are focusing the work of the Group of Twenty on these challenging, but crucially important, issues. I am hopeful that we will make substantive progress on them in the year ahead – an outcome that will strengthen the global economy and benefit all countries.