STABLE DISEQUILIBRIUM

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GLOBAL imbalances have shrunk somewhat in recent years, mainly because of the global downturn rather than deliberate policy actions. But the imbalances remain stubbornly high and there is a growing risk that, as before the global financial crisis, the world may be lulled into harmful inaction.

In the run-up to the Great Recession, such imbalances were acknowledged widely but not subject to any sustained policy corrections. The IMF did convene consultations involving countries ringing up large and persistent balance of payments deficits, such as the United States, and those accumulating significant surpluses, such as China and major oil producers. But these consultations did not get very far.

In the meantime, too many people fell into the trap of citing "special reasons" for why historically unsustainable imbalances could in fact be sustained. Instead, the imbalances ended up adding fuel to the global economic crisis.

Once again, there is a growing risk that the world will fail to tackle the imbalances—this time not just because of complacency but also because of the inability of economists and policymakers to converge on a common analysis. Without a common analysis it is difficult to forge effective policy agreements and a proper sense of shared responsibility between surplus and deficit economies.

There will eventually come a point when deficit nations will find it difficult to continue to spend massively more than they take in. Meanwhile, surplus countries will find that their persistent surpluses undermine future growth. For both sides, the imbalances will become unsustainable, with potentially serious disruption to the global economy.

Slow recovery

The world has yet to recover properly from the global financial crisis that erupted in 2008. Advanced economies are still trying to overcome sluggish growth, insufficient job creation, and rising inequality in income and wealth. Geopolitical risks, including those that push oil prices higher, have increased. And too many U.S. and European politicians dither and bicker rather than devise solutions to the structural impediments that undermine employment and growth.

Emerging economies continue to outpace their advanced counterparts, but their growth is slowing. The problems in advanced economies are a factor, but so is the difficulty of navigating the policy challenges of what Nobel Prize winner Michael Spence calls the "middle-income transition"—when a country's production costs rise to levels that make it harder to compete with low-income countries but its institutional capacity does not yet allow it to break into advanced economy territory.

It is in this global economic scenario that the rate of adjustment in current account imbalances that started after the global financial crisis has not been sustained (see chart), and the composition of the imbalances looks worrisomely similar to what it was before the crisis.

The adjustment that occurred happened for negative rather than positive reasons. It reflected the impact of the Great Recession on demand in advanced economies, with trade deficits in countries such as the United States declining as unemployment

Persistent, large payment surpluses and deficits threaten global long-term economic well-being and financial stability

rose to unusually high and persistent levels. The adjustment was later partially reversed as these economies began to recover—not on the back of sustained reforms but in large part due to massive liquidity injections by central banks and a once-and-for-all decline in the household saving rate.

The United States still accounts for a significant chunk of the underlying deficits—one-third today compared with one-half before the crisis. On the other side, just five countries account for half of the global surplus, similar to the precrisis situation.

In the most delicate and systemic of all bilateral imbalances—the China-U.S. trade balance—deterioration has continued, with the imbalance now greater than it was on average during 2006–08. Meanwhile, the major imbalance between Germany and countries on the periphery of Europe continues to serve as a complicating factor in an already complex and perplexing regional debt crisis.

Explaining imbalances

The persistence of imbalances has come with little resolution in the related academic debate over their causes, their significance, and what can or should be done to remedy them. If anything, economists seem more at odds than ever.

Without a common analysis, it should come as no surprise that policy initiatives have also disappointed. In country after country, domestic considerations have trumped global concerns. The glory days of international policy coordination that culminated in the highly successful April 2009 London Summit of the Group of 20 advanced and emerging economies (G20) have given way to rather bland meetings. And because the Mutual Assessment Program the G20 asked the IMF to oversee is still evolving, policy-driven progress on resolving the global imbalances has been limited.

Academic explanations tend to stress different factors for both the emergence of persistent global imbalances and the failure to address them. This adds to the problems of policymakers who already confront imperfect tools and reduced flexibility after what was, by any standard, an unusually aggressive use of fiscal and monetary measures to avert a global depression.

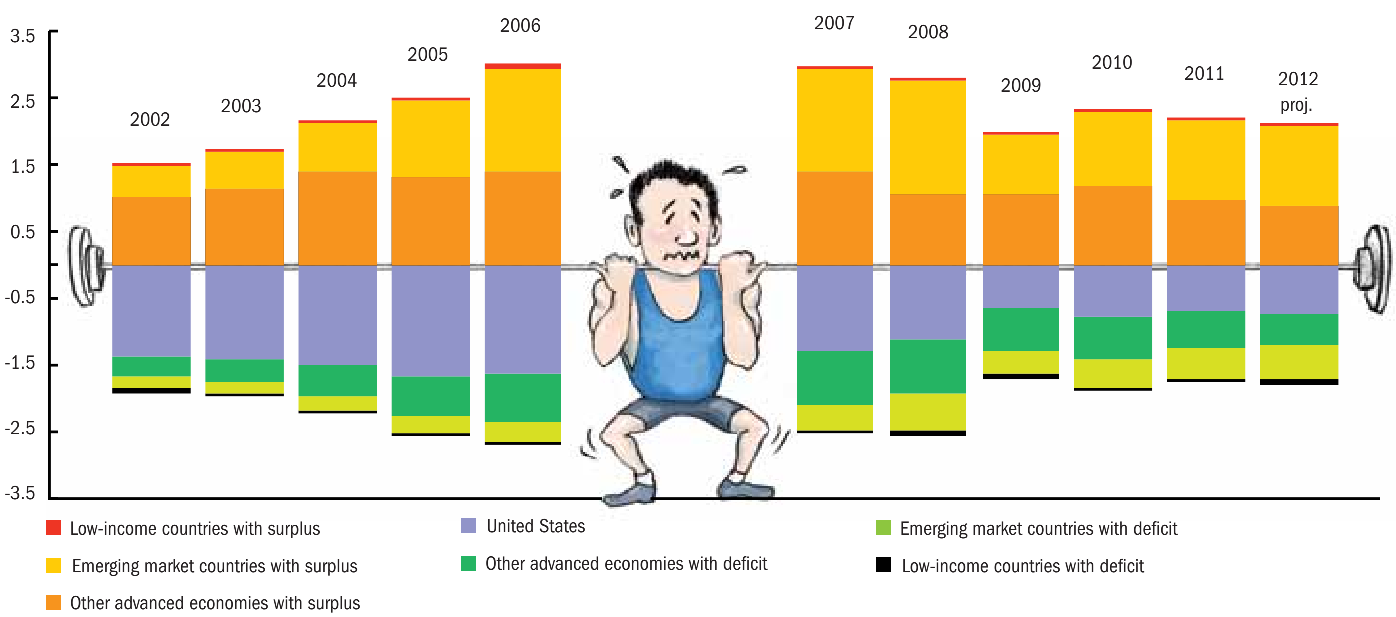
Some experts argue that the global imbalances are the outcome of macroeconomic policy choices. Others highlight the structural role of national savings and the ease with which surplus funds can be invested across national borders. Then there are those who view the imbalances as a reflection of the increasingly outdated structure of the international monetary system.

No single explanation dominates the literature and attains a critical level of consensus, which is more a reflection of the confusing times than a failure of the economics profession.

Imbalances persist

The narrowing of global balance of payments imbalances did not continue after the Great Recession.

(global current account imbalances, percent of world GDP)



Source: IMF, *World Economic Outlook* (2012).
Note: The global statistical discrepancy is not shown.

The global economy today is in the midst of *secular and structural* realignments at the national, regional, and international levels as relative dominance and dynamism shift from the older advanced economies to emerging market economies. These realignments are occurring during a period that includes a highly unusual economic downturn that spawned a degree of policy experimentation in advanced economies trying to shake the recession that not long ago would have been deemed unthinkable. These developments also explain why markets have tended to fluctuate violently—as investors alternate from being risk friendly to risk averse.

The outlook

Given these conditions, the best that we can expect from surplus and deficit economies in the months ahead is policy tinkering rather than major and sustained policy initiatives.

The U.S. economy will continue to heal gradually but is unlikely to see the set of structural reforms required to break out into vigorous and sustained growth. In Europe, the talk will be of reform, but financing issues will continue to dominate. And in emerging market countries, hesitancy about the uncertain global environment will preclude any major attempt to realign policies to favor both consumers and producers.

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Unless there is an economic catastrophe, it is difficult to envision much change in either the level or composition of global imbalances in the short term. The most likely baseline is one in which the world experiences more of the same.

This short-term outlook is far from comforting. Indeed, where most academics do not differ is in their concern that persistent imbalances expose the global economy to sudden stops in investment flows, as happened in the fourth quarter of 2008. At that time funds ceased flowing to emerging markets and sought safe havens like U.S. government securities, which is what happened more recently in Europe.

The extreme worries relate to currency fragmentation in Europe and worsening funding conditions for the United States. Both of these low-probability "tail events" entail catastrophic disruptions, with virtually no country in the world immune to negative spillover effects. Economists also point to mounting risks of currency wars and protectionism (a concern expressed on many occasions by Brazilian Finance Minister Guido Mantega).

The global imbalances are best characterized as being in a "stable disequilibrium." They can persist for a while. But if they do, the global economy will continue to travel farther afield from the equilibrium associated with high global growth, sustainable job creation, and financial soundness.

Two paths

There are two ways to resolve the inherent—and ultimately unsustainable—contradiction of a stable disequilibrium over the medium term.

The unpleasant resolution involves the advanced economies tipping once again into recession. This could occur from another flare-up in Europe's debt crisis, a further spike in the price of oil due to geopolitical disruptions, or a market accident due to still-excessive leverage in certain institutions and market segments. The policy responses would inevitably be less effective now that central bank balance sheets have ballooned to 20 to 30 percent of GDP in the major advanced economies while deficits and debt remain high.

The better resolution is one in which policymakers are proactive and preemptive. Such a resolution would likely have three facets: a simultaneous attack on both short- and long-term policy challenges; a series of midcourse corrections as more information about the effects of those policy changes becomes available; and a high degree of international coordination with the IMF playing a more effective and assertive role as conductor, information clearinghouse, and trusted advisor.

In this scenario the United States regains competitiveness and growth, Europe reforms itself into a more robust and harmonious economic union, and systemically important emerging markets encourage their growing middle class to consume as well as produce. All of these developments would have to take place simultaneously and would require the IMF to act as an effective and credible coordinator.

We should not underestimate the potential upside of such a comprehensive policy evolution. In addition to lifting impediments that have repeatedly undermined the global economy and exposed it to financial crises, such changes would have the added advantage of enticing the substantial private capital that is now standing on the sidelines. Such an influx of capital would be a further shot in the arm for investment, production, employment, trade, and more equal income distributions.

The well-being of millions of people around the world depends on the international community stepping up to this difficult challenge. ■

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