



BANK OF ENGLAND

# Speech

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Remarks Given by

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[Accompanying slides](#)

One spin off from the debate about global imbalances has been renewed interest in the international monetary system. It is a benign aspect of a potentially acrimonious debate about whether the scale and persistence of global imbalances – and specifically the US current account deficit – was made in the USA or made in Asia – or conceivably Europe (and maybe even the Middle East).

A better approach is to view global imbalances as the outcome of decentralised savings-investment decisions within an interdependent global system. And it's worth emphasising straight away that substantial imbalances may be the natural product of a healthy global monetary and financial system: they do not necessarily represent a problem.

But is the current pattern of large and persistent global imbalances healthy in this sense? Or does it reflect unsustainable behaviour on the part of policy makers, companies or private individuals around the world, rooted in unrealistic expectations, sub optimal economic policies or tensions between national policy objectives? Are global imbalances now on such a scale that their reduction inevitably poses a threat of some kind, whether to global activity, trade or financial stability? And does the current international monetary system embody sufficient incentives to deliver an orderly correction of imbalances?

At the risk of going over ground which was already covered yesterday, let me start by briefly reviewing the changing pattern of global imbalances. In doing so, the main point I want to make is that this is quite a complex story, which is consistent with several different – but not mutually exclusive – interpretations. And, hard as it is to understand, the past may not be much help in predicting the future.

The steady increase in the US current account deficit since the 1990s and its present unprecedented level – at over 6% GDP – has made it particularly tempting to look for home grown factors which can consistently explain this trend. But the pattern of US saving and investment underlying its current account deficit look very different in the pre and post 2000 periods.

The former period was characterised by sustained fiscal consolidation, leading to fiscal surpluses, together with a fast growth in private investment in response to high expected productivity in the US; the latter by an emerging fiscal deficit, in response to tax cuts, and a fall off in business investment. Only the steady downward trend in the household saving ratio – now into negative territory – is common to both periods.

This shift in the composition of the pattern of US savings and investment has coincided with a change in the composition of external financing flows into the US.

The private equity inflows which dominated in the earlier period fell sharply after the stock market crash, and were replaced by inflows into corporate and especially government bonds.

A significant proportion of the demand for US government securities came from the official sector, notably Asian central banks, whose foreign exchange reserves have more than doubled since 2001.

The fact that the US current account deficit has been funded at historically low and falling real interest rates suggests that the fall in US net savings may not have been the only – or even the main – driver of global imbalances. And while there are other possible explanations for the current low levels of global interest rates, it is certainly true that high saving relative to investment in East Asia has been an important counterpart of the US current account deficit. To be more specific, the rise in saving has outpaced the growth in investment in China, while domestic investment in the rest of East Asia remained stagnant after the Asian crises.

Finally, last year's doubling of oil prices in response to buoyant world demand has led to a further change in the pattern of imbalances, with the combined surpluses of oil producing countries now likely to equal half the US current account deficit, on the same scale as the combined Asian surplus.

How much of a threat might persistent imbalances on this scale pose to the world economy?

It is, of course, conceivable that these imbalances will prove to be relatively short lived. They might be driven by underlying influences that prove to be largely temporary – for example an investment overhang in East Asia, which is eventually worked off, or a purely cyclical divergence in growth rates between major regions, or a short lived spike in world oil prices. But at the moment there is little sign of this – rather the reverse.

It is therefore worth reflecting whether today's international monetary system (IMS) is sufficiently robust to ensure that global imbalances can be financed, contained or corrected through the normal mechanism of market forces, without crisis; or failing that, whether institutional arrangements exist to resolve collective action problems and conflicting priorities without damage to the wider world economy.

There are three key features of today's IMS which are particularly relevant in thinking about this question.

The first is financial globalisation which has totally transformed the landscape over the past two decades. Total financial wealth has risen sharply relative to GDP; and

investors are now able and willing to hold a higher proportion of their portfolios in external assets. The trend to larger external asset and liabilities has been particularly significant in industrial countries, whose external assets and liabilities relative to output roughly tripled between 1990 and 2003, reaching average levels of more than 200 per cent of GDP.

This has two effects. First, the expansion in external balance sheets has relaxed the constraints on the financing of countries' savings and investment imbalances. And second, balance sheet effects can have material impacts – affecting the link between current account deficits and external debt burdens, as well as the external adjustment process itself.

A corollary of financial globalisation has been the increased importance of market forces, rather than institutionalised inter government agreements, in providing incentives for policy makers within systemically important countries or regions to follow policies that are mutually consistent – notwithstanding the longevity of the Bretton Woods sisters (the IMF and the World Bank).

The second important feature of today's world is the rising economic importance of a group of Asian emerging market economies who heavily manage their exchange rates. As a result, the international monetary system has mutated into a 'hybrid' system in which some systemic countries float their exchange rates while others fix or manage them. One implication is that the pressure for adjustment to any given shock can be very asymmetric relative to a floating rate world. Thus, market driven exchange rate changes are likely to be concentrated on particular blocs rather than diffused across the system as a whole. As Obstfeld and Rogoff and others have pointed out, this is a situation which could create some difficult policy frictions. These have the potential to undermine free trade, and weaken world growth.

The third feature is the continued dominance of the US dollar as both a reserve currency as well an anchor for those countries that choose to fix or manage their exchange rates. But nowadays countries have choices. They might fix against the dollar but choose to hold at least a portion of their reserves in other major currencies. Since the advent of the euro, the dollar is no longer the only credible reserve currency.

How do these features of the international monetary system affect the risks associated with today's imbalances?

Financial globalisation has relaxed the constraints on countries in financing their savings investment imbalances, thus allowing larger imbalances to be sustained for longer. This is in principle welcome in so far as it permits more efficient adjustment over time, and smoothes the impact of economic shocks on real activity and

consumption. But it also poses major new challenges for creditors and debtors, both public and private sector.

The reason is that the price at which the market is willing to finance imbalances depends on investors' expectations about the future. This means that debtors in today's world face much greater uncertainty about when credit constraints will begin to tighten. So there is always a risk that a reassessment of the economic prospects of a debtor country might lead to a rise in external financing costs. But there is considerable uncertainty about whether – and when – such a reassessment might occur.

This uncertainty is particularly acute in the case of the US. Its dominant position in the world economy, its huge balance sheet and its reserve currency status make it special in a number of ways.

At present the US still earns positive net income from abroad despite a steady deterioration in the current account since 1991, and a slower rise in its net external indebtedness. This is not to imply that the US is immune to the basic arithmetic of debt sustainability – sooner or later persistent deficits will lead to levels of external indebtedness that represent a significant economic burden even on the US; but it is more than usually hard to predict how long this might take.

The dollar's central role in the foreign exchange policies of Asian emerging markets adds to the uncertainty about the deficit levels at which the US will face tighter credit constraints. Since the foreign official sector – mostly Asian central banks – have been financing a substantial part of the US current account deficit (in net terms) and now hold a substantial amount of the outstanding stock of US Treasuries, private investors' willingness to hold dollar assets depends to some extent on their expectations of what these Asian central banks will be doing.

Since many Asian EMEs already have far more reserves than they need for self-insurance against financial crisis, their appetite for continued accumulation of US dollar assets will at some stage abate: indeed there has been some anecdotal evidence of this over the past year. They can already choose to diversify their reserve holdings, and the options available may become more attractive to them with the development of Asian bond markets.

Their development strategies will also evolve. One-way intervention has potentially significant costs as well as benefits – costs which go well beyond the risk of substantial capital loss in the event of future exchange rate realignment. These include growing implementation problems, which are likely to be particularly acute in very open economies, and a potentially serious misallocation of domestic resources. It will not be in the interests of the Asian countries concerned to ignore these issues.

That is why I find the so called Bretton Woods II hypothesis – or at least the proposition that Asian central banks will have a more or less open ended commitment to financing ever increasing US deficits – rather implausible, at least as a prediction of what is likely to happen in the medium term, rather than as a description of the past few years. It assumes the continuation of unsustainable policies, which are not in the interests of the countries concerned. I concede however, that it is hard to make a precise forecast about the timing of a policy shift in Asia. And it is worth bearing in mind that this may depend on global and regional political considerations as much as on economic and financial pressures.

So given these uncertainties over the evolution of global imbalances, what should we do about them?

There is clearly no case for turning the clock back and re-introducing the constraints that characterised the genuine Bretton Woods system. The challenge is for policy makers to find ways of operating more effectively within the current system, to maximise the opportunities it affords and to manage the risks associated with open capital markets.

As a monetary policy maker, I am acutely conscious that a world of large imbalances carries some risk of disruptive market adjustments, even if the probability of them occurring is low. These could have a significant impact on economic activity, especially if they included a sharp reversion of long-term interest rates to something closer to their long-run average. We have been trying to factor this risk in to our thinking about interest rates as long as I have been on the MPC. But it is not a risk that maps easily on to any particular interest rate decision.

While the risk of a disruptive adjustment may still be low, the sheer scale of current imbalances increases the potential costs of policy mistakes and misperceptions. Any disconnect between what the markets expect and what policy makers intend to do becomes increasingly hazardous. That puts a premium on excellent policy communication, to reduce uncertainty and minimise the risk of sharp market corrections. And policy makers need to ensure that their policies are robust to the possibility that market expectations may not be consistent with economic fundamentals.

Policy makers in systemically important countries also need to be better at factoring wider political risks into their decision taking. They need to have an informed view of how markets and policy makers in other countries are likely to react, before they decide which domestic policies are likely to prove sustainable – and they need to ensure that their policies are robust to possible shifts in other countries policies. The key political risk at present is of course protectionism – not just the possibility of bilateral restrictions, but of a fatal lack of momentum on the Doha round. This could

be a material consideration in almost any scenario created by financial market pressures.

All these risks underline the need to greatly improve the standard of dialogue on international economic issues. The quality of analysis needs to improve, the right countries need to participate in the debate, discussions need to be franker, and their outcome needs to be communicated clearly.

Getting these things right will be tricky but the need for reform is growing. So I am sure we will need to address these issues soon. As to how we do it? That's for another day.