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Understanding Global Imbalances

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Abstract

Although there have been surplus and deficit nations in the world for some decades, the 2008 global financial crisis underscored the magnitude of the so-called global imbalances which provided the macroeconomic backdrop to the worst financial crisis in nearly a century. The two key players are the United States and China, which have been the twin major engines of growth in the world economy since the 1980s. But, the changed global economic structure involves many more nations, specifically the rise of emerging economies in the early 1990s. The global economy fundamentally changed then with the take-off of the "open door" policy in China in 1992, the switch to export-oriented from import-substitution policies in India after its 1991 balance of payments crisis, and the re-joining of Eastern Europe after the fall of Communism in the former Soviet bloc at the start of the 1990s. These nations together doubled the global labour force to three billion people, which effectively halved the capital-to-labour ratio in the world. This led to falling wages and therefore lower prices, including the cost of imports into rich economies. The deflationary effect, particularly of China with its 700 million labourers, meant that inflation was low throughout the 2000s whilst growth was strong and thus allowed interest rates to stay low in the West. Capital was cheap both in terms of price and also in returns given the additional labour in the global economy. Rapid growth and plentiful liquidity led to consumption via borrowing in the U.S., while export-oriented economies accumulated ever-increasing amounts of foreign exchange reserves. The consequence of which was a flattening of the U.S. bond yield curve since there was a growing demand for dollar-denominated assets by emerging economies in developing Asia and amongst Middle Eastern oil exporters to maintain stable exchange rates while their current account surpluses grew. The other side of the deflationary effect of China and other surplus economy was upward pressure on commodities, generating a supply side boom that peaked in the summer of 2008. The rise in energy prices furthered fuelled the accumulation of reserves in the Middle East throughout the 2000s.

In 2001, after the bursting of the U.S. dot.com bubble, loose monetary policy in the United States fuelled a further asset bubble in sub-prime mortgages. With inflation targeting in place, the low inflation rate did not flag the need for higher interest rates even though there was excess liquidity in the economy chasing yields. When interest rates started to rise in 2004, the downward pressure on the yield curve kept both long- and short-term interest rates low which fuelled the housing bubble until it burst in the summer of 2007. Global imbalances, therefore, provided the context to the current crisis. Although longstanding, the shift to independent central banks and the trend of financial de-regulation since the late 1980s coincided with a changed global economy. This paper seeks to understand the interactions of the U.S. and China throughout this period within the larger context of the global economic crisis. Using a gravity model, the respective weights exerted by the U.S. and China will be investigated to shed light on the pull and push factors of the global macroeconomic identities of current account surpluses/deficits, global net savings, and the drivers of foreign exchange accumulation. By understanding better the drivers of the

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global imbalances, recommendations can be put forward to assist in the process of re-balancing and recovery from this historical financial and economic crisis.

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1. The Changed Global Economy of the 1990s

Although there have been surplus and deficit nations in the world for some decades, the 2008 global financial crisis underscored the magnitude of the so-called global imbalances which provided the macroeconomic backdrop to the worst financial crisis in nearly a century. The two key players are the United States and China, which have been the twin major engines of growth in the world economy since the 1980s. But, the changed global economic structure involves many more nations, specifically the rise of emerging economies in the early 1990s. The global economy fundamentally changed then with the take-off of the "open door" policy in China in 1992, the switch to export-oriented from import-substitution policies in India after its 1991 balance of payments crisis, and the re-joining of Eastern Europe after the fall of Communism in the former Soviet bloc at the start of the 1990s. These nations together doubled the global labour force to three billion people, which effectively halved the capital-to-labour ratio in the world. This led to falling wages and therefore lower prices, including the cost of imports into rich economies. The deflationary effect, particularly of China with its 700 million labourers, meant that inflation was low throughout the 2000s whilst growth was strong and thus allowed interest rates to stay low in the West. Capital was cheap both in terms of price and also in returns given the additional labour in the global economy. Rapid growth and plentiful liquidity led to consumption via borrowing in the U.S., while export-oriented economies accumulated ever-increasing amounts of foreign exchange reserves. The consequence of which was a flattening of the U.S. bond yield curve since there was a growing demand for dollar-denominated assets by emerging economies in developing Asia and amongst Middle Eastern oil exporters to maintain stable exchange rates while their current account surpluses grew. The other side of the deflationary effect of China and other surplus economy was upward pressure on commodities, generating a supply side boom that peaked in the summer of 2008. The rise in energy prices furthered fuelled the accumulation of reserves in the Middle East throughout the 2000s. Until the onset of the 2008 global financial crisis, this period had been called the 'nice decade' or the 'Great Moderation' since it marked an era of strong growth, low inflation, and therefore low interest rates.

2. Independent Central Banks & Financial Deregulation

The changes in the global economy coincided with the early 1990s movement to create independent central banks (starting in New Zealand in 1991 and was undertaken by the UK and European Central Bank or ECB in the late 1990s) which has also been credited with increasing transparency about monetary policy. However, targeting asset bubbles was not part of such mandates, and this became an evident problem during the 'Great Recession' which followed the near-collapse of the banking system in the West. It wasn't only monetary policy which changed. Financial de-regulation since the 1980s also led to financial innovation that had led to the abandonment of the previous targeting of monetary aggregates (e.g., M2) by Western central banks. Because of the growth of financial intermediation and globalised