Embargoed until presentation time on 1 September 2006.

Panel Discussion

Global Imbalances: 'Hard' or 'Soft' Landing? Implications for Monetary Policy

Krzysztof Rybinski

Deputy President

National Bank of Poland

‘Hard’ and ‘soft’ landing are aeronautical terms. Many decades ago plane crashes were so alarmingly frequent, that some believed that every flying plane was an accident waiting to happen. Today, the advance of technology makes the past concerns look ridiculous; plane crashes are rare and require exceptionally adverse weather conditions, human failure or a terrorist attack. Likewise, large current account deficit in the United States and large current account surpluses in China and oil-exporting countries, jointly labelled as global imbalances are considered as unstable just as planes used to be several decades ago. Similar aeronautical vocabulary – hard landing, soft landing, crash etc. – is also used to describe the range of possible outcomes for the global economy, which embarked on a global imbalances journey about ten years ago.[1]

The title of this panel asks two questions: (1) Will global imbalances unravel in orderly or disorderly fashion, and (2) how should monetary policy react in either of the imbalances unravelling scenarios?

Answering these questions requires a closer look at three crucial elements of this flying global economy airplane:

- What factors are responsible for the emergence of global imbalances?
- What are the flying and landing conditions?
- Are pilots taking proper actions to land safely?

But before I proceed to address these issues let me mention that the views presented today are mine and do not necessarily reflect the official position of the National Bank of Poland.

How did we get into global imbalances?

The need to identify the type of the flying airplane and its technical conditions implies that one has to understand the nature of global imbalances. And here we run into the first problem, as the top 'aviation specialists', including 'pilots' themselves cannot agree on that. I have identified at least nine major views about the nature of global imbalances, namely[2]:

- emergence of the new Bretton Woods regime[3]. This concept was put forward by Michael Dooley - who is on the panel with us today - David Folkerts-Landau and Peter Garber, who argue that a new world equilibrium has emerged and it is in the best interest of both the United States and China to continue financing consumption of American households with Chinese savings until Chinese economy reaches a status of a developed economy, so the new Bretton Woods can last for many years;
- global savings glut hypothesis was proposed by Ben Bernanke[4], who postulates that the shock causing global imbalances originated from Asia as a result of excessive saving rates;
- global investment drought hypothesis advocated by the IMF[5], which puts emphasis on low Asian investment following the Asian crisis in creating savings-investment imbalances in these countries;
- negative US savings, in the household sector stimulated by stock exchange bubble and later by a lot of local housing bubbles[6]; and in the public sector, however there are very different estimates about the impact of the budget deficit in the United States on the US current account deficit ranging from 0.2 to 0.5[7];
- effects of Asian crises in 1990s combined with the pursuance of export-led growth model in Asia[8];
- shocks changing the relative investment prospects of various parts of the global economy[9], such as productivity shock in the United States in the mid-1990s or the inability of Asian countries to generate good quality financial assets;
- much higher rates of return enjoyed by United States on its foreign assets than the cost of its foreign liabilities[10], this cushioned the trade deficit impact on net international investment position and was labelled as US 'exorbitant privilege';
- global imbalances are optimal choices of rational US consumers[11], who expect that the USA will account for a bigger share of global GDP in the future;
- there are theories about imbalances originating from the statistical offices' failure to account properly for the US exports of 'dark matter'[12].

I would argue that none of the above hypotheses is able to explain fully the origins and mechanisms of global imbalances. In my view the most plausible chain of events that led to the emergence of global imbalances appears as follows:

- massive ICT deepening in US ICT using industries (such as retail and wholesale trade) led to significant productivity improvements relative to other parts of the world (most notably relative to Europe), corporate investments in intangibles (intellectual capital) further enhanced this trend beyond what was captured by official statistics;
- this has made the USA a very attractive place to locate world savings, supported by very well developed financial markets infrastructure and high liquidity of US assets;
- Asian crisis led to a sizeable drop in Asian investments, resulting in global savings glut further supported by a an export-led growth strategy adopted by Asian countries and a strong precautionary motive to build large foreign exchange reserves to insulate Asian economies from future sudden stops;
- global savings surplus combined with historically low interest rates supported the emergence of the housing bubble, which increased consumers' wealth, while financial innovations made it possible to translate this wealth gain into increase in real consumption, with houses turned into ATMs;
- over the last two years oil-producing countries also contributed to the built-up of global imbalances amid large and persistent rise in oil prices, as documented in the IMF's World Economic Outlook in April 2006[13].

The weather conditions

Even if my description of the origins of global imbalances is correct it will not help much to predict what will happen next amid uncertain weather outlook. So far the global imbalances flight has been somewhat bumpy, while headwind coming from steadily rising oil prices proved less disruptive than expected. But in general the weather conditions were favourable, mostly thanks to significant productivity gains in the US and in emerging Asia and thanks to the rapidly advancing global trade and financial integration. Inflation, despite large commodities' prices increases remained low and so did interest rates in relation to their historical averages. While the weather forecast for tomorrow appears rosy as well, there is a considerable uncertainty regarding the medium-term forecast. Let me point to a few risks:

- Bursting of the US housing bubble may lead to a US or even worldwide recession;

- Chinese economy continues to pace ahead, and one can only keep guessing whether improvements in the functioning of its financial system will arrive quickly enough to cushion the looming bad loans problem;
- There is a considerable uncertainty regarding future oil prices, further sizeable increases may lead to elevated inflationary pressures and may choke off economic growth, leading to global stagflation;
- While the benefits of financial integration are immense, there is considerable uncertainty and lack of information regarding the distribution of various types of risks across markets and across types of investors, with rapidly growing derivatives markets and hedge funds as a possible sources of future volatility;
- Even in a soft-landing scenario for the US economy – which remains the core scenario for the majority of forecasters – many emerging markets may experience sudden-stops amid rising risk premia and 'flight to quality';
- It is unclear whether global trade integration will encounter new protectionist barriers;
- If real effective exchange rate depreciation of the dollar is an inevitable part of the solution of global imbalances, still a big "IF", then some central banks will find it increasingly more difficult to explain to citizens in their counties why they are holding large amount of assets which are expected to loose in value. These concerns have already been manifested by publicly announced decisions to reduce the dollar share of reserves in Poland, Sweden, Russia and Italy. Also authorities in other countries have publicly signalled such a possibility, while the largest reserve holder, Peoples Bank of China keeps suggesting that some diversification of its reserves may be desirable over the medium term. It remains to be seen whether the trend of reducing dollar exposure by smaller central banks will be followed on the aggregate, and what impact this will have on the currency composition of assets held by the private sector.

I have named just a few risks from a much longer list. It appears that while consensus forecast calls for global imbalances to unfold "at the pace that is likely to be measured", in reality the outcome will be "weather-dependent" and will also depend on the policy-measures taken by key "stakeholders" of the global imbalances.

Are pilots taking proper actions?

Most economists and central bankers agree on a range of reforms that need to be undertaken in order to raise the likelihood of soft-landing for the global economy. These reforms include:

- reducing budget deficit in the USA and increasing private savings, especially those required by future pension and healthcare needs of US citizens;
- implementing structural reforms in the euro area and in Japan to raise potential output in these regions;
- advancing reforms of Chinese financial sector, including a greater opening-up to foreign capital, which should be followed by greater exchange rate flexibility;
- rebalancing the Chinese growth model from export-led at any cost into a more domestic consumption driven, with due consideration given to international standards (environmental, property rights, human rights);

Some economists would argue that even introducing the above-mentioned reforms would not prevent unpleasant adjustment of the dollar exchange rate (Edwards, 2005)[14], and some even see a risk of the dollar loosing its leading reserve currency status (Chinn, Frankel, 2005)[15].

It appears that while some reforms have been taking place in various parts of the global economy, their pace and scope remains inadequate to the challenges posed by global imbalances.

How should monetary policy respond?

As I have mentioned earlier monetary policy had probably contributed to the acceleration of the built up of the housing bubble in the US, which fuelled the global imbalances. A recent Wall Street Journal editorial suggests, that after staying easy for too long, now monetary policy should focus on re-establishing the Fed anti-inflationary reputation[16]. I think that the author of this article reached a wrong conclusion, as there are no reasons to question the Federal Reserve commitment to price stability. However, there is no consensus indeed on how monetary policy should react to a build-up of sizeable imbalances or bubbles. Some economists argue that the central bank should burst bubbles in order to avoid even worse outcomes in the future (Roubini, 2006)[17]. Others argue that central banks should not burst bubbles because the link between monetary conditions and asset prices is far less tight than most commentators suggest and bubbles themselves do far less harm to an open economy upon bursting than commonly assumed, unless there are significant problems in the banking sector (Posen, 2006)[18]. Therefore it appears that the most effective way to deal with asset price bubbles is a proper supervision policy and not the interest rates changes.

Another question is not if, but when the central bank should act. For example, Alan Blinder and Ricardo Reis came up with a term “mop up after strategy”[19], which refers to a situation when monetary policy allows for a bubble to be built, but once it bursts it insulates the financial system and the economy from the fallout. The authors clearly prefer the mop up after strategy to bubble bursting one, and they find no evidence that a so-called “Greenspan put” exists.

Donald Kohn, now the Vice Chairman of the Board of Governors of the Federal Reserve System coined a phrase “extra action policy”[20], which allows for a deviation of current inflation from a level determined as stable in return for improving the prospects of achieving price stability in the future. However, the extra action policy does not mean piercing the speculative bubbles by central banks, and rather means “buying” an additional insurance against possible negative shocks, which may happen in the future. In Kohn’s opinion, the extra action policy may be run very rarely and only where the following three conditions are met:

- the central bank must be able to identify asset bubbles in a timely manner and with high certainty as to the correctness of analysis conclusions;
- there must be a high probability that a slight tightening of the monetary policy will be able to stand against the speculative activity on a given assets market;
- the expected improvement of the future economic situation resulting from a smaller speculative bubble must be significant and higher than the costs incurred by the economy in the aftermath of running the extra action policy.

To recapitulate this train of thought, I am skeptical whether the three above-mentioned conditions can be sufficiently met nowadays; however, I do not preclude that in the future, the understanding of economic processes will improve as much as to enable running the Kohn’s extra action policy where reasonable.

So what are the implications of the global imbalances for monetary policy? Despite the lack of consensus among economists and central bankers I would suggest that we have come to agree on three issues:

- **Firstly, monetary policy should be fully committed to maintaining price stability, treating both too high and too low inflation as undesirable outcomes.** At the end of the global imbalances episode, irrespectively of what landing scenario actually takes place, it is the ability of the monetary policy to anchor private sector expectations in line with low and stable inflation that will be the necessary condition for achieving financial markets stability and for a continuation of the Great Moderation era;
- **Secondly, proper prudential measures and proper supervision policy should be in place** to ensure that sharp asset price increases do not translate into deterioration of asset quality of the banking sector upon bubble bursting; and

- Finally, regardless of whether you expect a soft or a hard landing, you should always keep your seat-belt fastened.

Thank you for your attention.

---

[1] I borrowed this aeronautical comparison from a recent paper by Calvo G. and Talvi E. (2006) "The Resolution of Global Imbalances: Soft Landing in the North, Sudden Stop in Emerging Markets?", CERES, Documentos de Trabajo.

[2] This list is based on Rybinski K. (2006) "Global imbalances", forthcoming in Ekonomista (in Polish).

[3] Dooley M., Folkerts-Landau D., Garber P. (2003) "An Essay on the Revived Bretton Woods System", NBER Working Paper 9971; Dooley M., Folkerts-Landau D., Garber P. (2004) "The Revived Bretton Woods System: The Effects of Periphery Intervention and Reserve Management on Interest Rates and Exchange Rates in Center Countries", NBER Working Paper 10332; Dooley M., Folkerts-Landau D., Garber P. (2004) "Direct Investment, Rising Real Wages and the Absorption of Excess Labor in the Periphery", NBER Working Paper 10626; Dooley M., Folkerts-Landau D., Garber P. (2004) "The US Current Account Deficit and Economic Development: Collateral for a Total Return Equity Swap", NBER Working Paper 10727; Dooley M., Folkerts-Landau D., Garber P. (2005) "Savings Glut and Interest Rates: the Missing Link to Europe", NBER Working Paper 11520.

[4] Bernanke B. (2005) "The Global Saving Glut and the U.S. Current Account Deficit", Remarks by Governor Ben S. Bernanke At the Homer Jones Lecture, St. Louis, Missouri Updates speech given on March 10, 2005, at the Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia.

[5] Rajan R. (2006) "Perspectives on Global Imbalances", Remarks by Economic Counsellor and Director of IMF Research Department at the Global Financial Imbalances Conference London, United Kingdom, 23 January 2006; and Rato R. (2006) "Shared Responsibilities: Solving the Problem of Global Imbalances", Speech of the International Monetary Fund Managing Director at the University of California at Berkeley, 3 February 2006.

[6] Greenspan A., Kennedy J. (2005) "Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences." Federal Reserve Board, Finance and Economics Discussion Series Paper 2005-41; Lansing K. (2005) "Spendthrift Nation", FRBSF Economic Letter, November 2005.

[7] Greenspan A. (2005) "Current Account" presentation at Advancing Enterprise 2005 Conference (London, United Kingdom), 4 February 2005; OECD (2004) "Economic outlook", June 2004; Faruqee H., Laxton D., Muir D., Pesenti P. (2005) "Current Accounts and Global Rebalancing in a Multi-Country Simulation Model", presented at the NBER conference, "G-7 Current Account Imbalances: Sustainability and Adjustment", 1–2 June 2005; Chinn M. (2005) "Getting Serious about Twin Deficits", working paper, The Bernard and Irene Schwartz Series on the Future of American Competitiveness, CSR No. 10, September 2005.

[8] Gruber J., Kamin S. (2005) "Explaining the Global Pattern of Current Account Imbalances", Board of Governors of the Federal Reserve System International Finance Discussion Papers Number 846, November 2005; Mendoza R.(2004) "International Reserve-Holding in the Developing World: Self Insurance in a Crisis-Prone Era?" Emerging Markets Review 5(1); Aizenman J., Lee J. (2005) "International Reserves: Precautionary vs. Mercantilist Views, Theory and Evidence", IMF Working Paper WP/05/198, October 2005; Gosselin M-A. Parent N. (2005) "An Empirical Analysis of Foreign Exchange Reserves in Emerging Asia", Bank of Canada working paper 2005-38, December 2005; EBC (2006) "The Accumulation of Foreign Reserves", Occasional Paper No. 43, International Relations Committee Task Force, February 2006.

[9] Caballero R., Farhi E., Gourinchas P. (2005) "An Equlibrium Model of Global Imbalances and Low Interest Rates", mimeo, MIT, September 2005; Faruqee H., Laxton D., Muir D., Pesenti P. (2005b) "Smooth Landing or Crash? Model-Based Scenarios of Global Current Account Rebalancing", NBER working paper 11583, August 2005.

[10] Gourinchas P-O., Rey H. (2005) "From World Banker to World Venture Capitalist: US External Adjustment and The Exorbitant Privilege", working paper UC Berkeley, August 2005; Lane P., Milesi-Ferretti HG-M. (2005) "Financial Globalization and Exchange Rates", IMF Working Paper WP/05/3, January 2005; Lane P., Milesi-Ferretti G-M. (2005b) "A Global Perspective on External Positions", IMF mimeo, July 2005.

[11] Engel C. Rogers J. (2006) "The U.S. Current Account Deficit and the Expected Share of World Output", NBER working paper 11921, January 2006;

[12] Hausmann R., Sturzeneger (2005) "Global imbalances or bad accounting? The missing dark matter in the wealth of nations", Harvard University working paper, December 2005.

[13] International Monetary Fund (2006) "Oil Prices and Global Imbalances", World Economic Outlook, chapter 2, April 2006.

[14] Edwards S. (2005) "Is the U.S. Current Account Deficit Sustainable? And if not, How Costly Is Adjustment Likely to Be?", NBER working paper 11541, August 2005.

[15] Chinn M., Frankel J. (2005) "Will the Euro Eventually Surpass the Dollar As Leading International Reserve Currency", NBER working paper No. 11510, August 2005.

[16] Wall Street Journal (2006) "The House the Fed Built", editoral, 28 August 2006.

[17] Roubini N. (2006) "Why Central Banks Should Burst Bubbles", mimeo, Stern School of Business and Roubini Global Economics, January 2006

[18] Posen A. (2006) "Why Central Banks Should Not Burst Bubbles", Institute for International Economics Working Paper WP 06-1, January 2006

[19] Blinder A., Reis R. (2005) "Understanding the Greenspan Standard", paper presented at the Federal Reserve Bank of Kansas City symposium *The Greenspan Era: Lessons for the Future*, 25-27 August 2005.

[20] D. Kohn "Remarks by Donald Kohn at Monetary Policy: A Journey from Theory to Practice, An ECB Colloquium held in honor of Otmar Issing", 16 March 2006.