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The Risk of a Resurgence of Global Imbalances

Eswar Prasad

What a difference a year makes. The Lehman bankruptcy a year ago triggered something that was previously unfathomable—the near-collapse of the U.S. financial system, with enormous collateral damage to the global financial system and the world economy.

Remarkably, financial systems around the world have stabilized and the economic recovery has begun. Whether this is due to the resilience of economies and financial markets or the sagacity of policymakers who responded to the crisis with massive macroeconomic stimulus and other measures to prop up their domestic financial systems is already being hotly debated.

This debate matters greatly in terms of the timing of "exit strategies" to withdraw these measures. Huge fiscal deficits and large amounts of liquidity sloshing around could create their own collateral damage in the future. But declaring victory prematurely could stall a recovery that is weak at best. The advanced economies, in particular, still face a lot of headwinds including rising unemployment rates, weak household and financial sector balance sheets, and tepid domestic demand.

As we contemplate the future, it is useful to reflect on what got us into such desperate circumstances in the first place. Not so much to assign blame—and there is certainly plenty of blame to go around—but to try and fix the core problems. Weaknesses in financial regulatory systems, abetted by regulatory failures and an under-appreciation of how leverage could generate systemic rather than institution-specific risk, were a key problem. Investment managers faced perverse incentives to take large gambles that could bring down not just their institutions but the whole edifice. Measures are being taken, even if in a rather timid manner, to deal with these problems.

Whatever the root causes of the financial crisis, the problems clearly festered and resulted in a cataclysmic conclusion because of global macroeconomic imbalances—a consumption binge in the U.S. and a few other industrial economies financed by excess savings in Asia and other emerging market countries.

Astonishingly, the world is again looking to the U.S. to pull the global economy out of its slump and as a safe haven to stash cash until that happens. Consider China. Its economy has rebounded strongly after hitting a wall at the end of last year, thanks to an investment binge fueled by government spending on infrastructure as well as massive bank lending. The surge in bank lending—more than a trillion dollars in the first half of 2009!—is likely to create further excess capacity in some industries where there is already spare capacity. A healthy bottom line in terms of GDP growth cannot disguise the reality that employment and household income growth are unlikely to keep pace with output growth.

So China will continue looking for export markets to absorb its excess capacity and generate employment growth. Even large advanced economies like Germany and Japan are still quite dependent on exports, without which their incipient recoveries could stall. So this could leave the U.S. as the demander of last resort, which would hold back its own recovery and perpetuate the old problem of global imbalances.

The U.S. consumer has of course retreated into a shell after the sharp fall in household wealth. This has left the U.S. government to take up the slack, running up a deficit of $1.6 trillion this year (11.2 percent of GDP) and expected to add $9 trillion to the public debt over the next decade. The sheer size of this borrowing requirement means that it will soak up not only savings from the U.S. but from other countries.

Far from being reluctant providers of credit to the U.S., China and other emerging markets now have an even stronger motive to build up foreign exchange reserves and purchase more U.S. treasury bonds. After all, the crisis has shown that massive disruptions to the global financial system are not a thing of the past and that moderate levels of self-insurance in the form of reserves may not provide adequate protection.

I have proposed a global insurance scheme that would allow countries to directly purchase insurance against crises, removing the stigma of depending on an institution like the IMF to save them from crises. By contrast, self-insurance is not a good solution for individual countries and could perpetuate global imbalances. [see http://www.brookings.edu/opinions/2009/0310_insurance_prasad.aspx]

In the absence of coordinated solutions, we could be back where we started on global imbalances. The U.S. needs to develop a coherent plan for bringing its deficit back to reasonable levels, China and other surplus countries have to take measures to boost their domestic demand, and economies like Japan and Germany should reform their labor and product markets and financial systems. These have to be supplemented with measures to reform the international monetary system to reduce incentives for surplus countries to perpetuate imbalances.

What this crisis has shown is that there is now a national as well as international dimension to all of these problems and their solutions. We will all swim or sink together.

The author is a professor at Cornell University and a senior fellow at the Brookings Institution.