A simple solution to global imbalance that is easy to implement and is unlikely to make matters worse
Transcript

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Simple Micro-Economic Remedies to Global Imbalances

Avinash D. Persaud [1]

Abstract

The issue of global imbalances has been mis-diagnosed as a macro-economic problem when it is really a micro-economic one. Given structural reasons for the desired savings and investment imbalances around the world, current account imbalances of the same order and general direction would be found if the financial system was functioning well, exchange rates were fully flexible and there was free capital mobility. What would be different, however, would be the composition and specific direction of global capital flows. This suggests that the real problem is not one of elusive global macro risks but one of allocative-efficiency that can be solved without grand policy co-ordination.

If emerging market central banks are managing liquidity then their current asset allocation is appropriate and reflects good risk management. If, however, they are really managing the recycling of national savings in the absence of mature financial systems (as others also argue, such as the Bretton Woods II school) then the current asset allocation is inappropriate and risky, being too highly concentrated by currency and asset and overly insured against liquidity risks when liquidity risks are low for a long-term, future generations fund. A risk-free asset-allocation for future generations funds that can earn in the "short-run" the liquidity and market risk premia, would be pareto-efficient. It would boost investment returns in emerging markets; would boost investment in government-related (high-credit) infrastructure projects in other emerging markets; and would support investment discipline in the United States.

The Politics Of Imbalances

One of the underlying motives that lay behind John Maynard Keynes' proposals in the summer of 1941, for an international fund, bank and trade organization, was to de-politicise international economic relations [2]. From the 1930, Smoot-Hawley Tariff Act, to its retaliatory responses such as the 1933 Ottawa Agreements, Lord Keynes had witnessed the ill-effects of the pursuit of national or narrower political interests in the conduct of international economic and trade policy.

So it is a sad reflection of the current state of the post-war financial architecture that the debate on global imbalances is so politicized today. Whatever the rights and wrongs of the proposed policies, to have a national legislature blackmailing a foreign country with the threat of punitive tariffs if they do not revalue their exchange rate, is a highly dangerous precedent [3]. One cannot believe in a liberal multilateral trade system and not decry this development. The more politicized trade and financial relationships are, the less good policy outcomes will be for all. The citizens of Indonesia would be justified in questioning whether their interests are best served by whatever happens to go down well come election time in the living rooms of Ward 62 in Columbus, Ohio [4]

A Useful Counterfactual

One of the ways to cut through the politics of global imbalances is to ask what would happen to global imbalances if there were no capital controls, no foreign exchange intervention and mature financial systems everwhere. One might add mature bankers everywhere too but lets not wish for everything. It is very telling that it is quite uncertain whether current account imbalances would be any different in size than they are today. This suggests that, as with most things, fiddling around with exchange rates is not a lasting solution to any fundamental problem. I say that with no animosity to foreign exchange markets, having been employed to forecast them for most of my financial career.

Let us consider how the major commodity exporters would fare in this brave new world. We must bear in mind that commodity exporters account for as much of the rise in global trade imbalances since 1997 as any other meaningful grouping of countries. The current account position of Russia and the Middle-East alone, so excluding major Latin and African exporters, improved by $175bn between 1997 to 2005, the same improvement as observed by the Newly Industrialised Asian Economies plus China. Would these countries be, "earning more than they could spend at home", and therefore running large current account surpluses and capital exports? Yes. And this would be the right thing for them to do.

Would their exchanges rates be stronger? We can't actually tell by simply looking at the way the balance of payments actually balance ex post. There will be the political temptation to invest the new revenues at home especially as commodity exporters like Russia, the Middle-East and elsewhere, start off with substantial assets already invested abroad. This local investment activity might boost demand for the local currency.

But the reality is that the capacity to absorb new revenues in emerging markets is modest. The turmoil in Middle-East equity markets in the first half of 2006 is an indication of over-investment of oil revenues at home that may have been more profitably invested abroad. So the answer to the currency question is that if all "commodity-related” currencies were fully floating they would probably be higher than some of them are today. But for those economies that are critically dependent on commodity exports, this would probably reflect a policy mistake. Avoiding the Dutch Disease [5] by holding exchange rates steady and using the windfall to invest for future generations when the oil runs out or the price falls back would probably be a more sustainable policy. This is largely what is happening. Which is why commentators cannot easily get worked up about this substantial chunk of the global imbalance.

An important corollary to this conclusion is that the commodity exporters have developed agencies and investment strategies to manage the external investment of commodity windfalls for future generations. Many will be familiar with the Norwegian Oil Reserve Fund or its antecedents like the Kuwait General Reserve Fund that was established in 1960. The recent commodity boom has given birth to some new funds such as the Trinidad & Tobago Reserve Fund and the Chilean Pension Reserve Fund. Today commodity-related reserve funds around the world own in excess of $1trn of assets. Critically, the asset allocation of these funds is very different from that of their central bank cousins with substantially greater exposure to equity and emerging market equity risk. We shall return to this important point later.

What Would Happen To Global Imbalances If China Removed Capital Controls And Floated The Renimbi?

China is often singled out as the major player behind global imbalances. This is not a fair reflection of the reality but let us play along with this focus on China and ask what would China’s external accounts look like in a world of no capital controls, no foreign exchange intervention and a mature financial sector. Remember we ask the question in order to helps us consider what the problem is and what the right answers may be. Would China still earn more than it is spending locally and so run a current account surplus and export capital? Careful consideration suggests that it would. Recent analysis of developments in access to health, education and social security, along with demographic transitions suggests that we should expect Chinese savings rates to be high and rising amid a rapidly growing economy [6]. Demographic factors, along with economic history, are ignored by those who paint Asia as having a culturally pre-determined requirement to save excessively. Yet it is critical. If China’s savings rate reflects a desired outcome, due to demographics and other factors, then hoisting an exchange rate revaluation will only reduce the savings rate by lowering income and is unlikely to do anything to the savings and investment gap that determines the current account [7]. It is unclear that the world needs a Chinese recession at the same time as economic activity in the US is beginning to moderate.

China’s absorptive capacity for investment is far higher than many Middle-Eastern economies, but at any point in time, it has a limit. In China and other developing countries there will be times when investment opportunities are not as good as they were before, or not as good as they will be, and the best use of local savings is to invest them abroad. It is, incidentally, why we have an international financial system. Under free capital mobility a high and rising savings rate, colliding with a period of local investment exhaustion or over-investment would lead to large capital exports and a current account surplus. The currency implication is ambiguous – depending on the causation, the capital outflows may drive the currency lower or the trade surpluses may push it higher. However, if China were to remove capital controls today we would expect capital exports to surge to such an extent, as the private sector scrambled to acquire external assets as a risk diversifier, that the currency would depreciate. (Proposing that a country revalues its currency while retaining capital controls to stop the currency from falling is perverse.)

The big difference from where we are today in Asia and where we would be in a world of free capital mobility, floating exchange rates and a mature banking sector, is not the size of the savings investment gaps or the level of the exchange rate. Instead, the difference lies in the *who is managing capital exports and for what purpose.* In a world of free-capital mobility and a desire to spend and invest locally less than is earned, we would expect to see the private sector investing long-term savings abroad. If from time to time, and based on an assessment of investment opportunities, the Chinese private sector invested a significant part of China’s pension assets abroad, would we object? I don’t think so. The problem has been falsely diagnosed in terms of the size of the savings and investment gap and is more of a micro-economic nature than macro-economic. This will disappoint many as macro-economics seems so much sexier.

In China today the private sector does not have the long-term savings institutions to perform this role and so the public sector replaces it. But while the public sector can take the place of the private sector in terms of recycling the amount of capital abroad, its asset allocation is very different from that which a long-term investor would choose. There is an agency problem here. We do not select our central bankers and design their institutions for them to be risk takers. They are liquidity managers and they have been recycling savings as a liquidity manager would, in the safest most liquid investment, US Treasuries. Yet if central banks are in effect performing the task of a national pension fund, putting assets abroad when they would be better invested there, then this is an inappropriate allocation.

A Short Aside On Risk Appropriateness Relevant To Public Investment

If the State Agency for Foreign Exchange (SAFE) in Beijing is managing a reserve for liquidity purposes, then investing it in US or Euro denominated, short-term government instruments is an appropriate and low risk way to do it. However, if SAFE is managing an investment fund for future generations of Chinese, then investing it in this way is inappropriate and risky for the beneficiaries. In its currency choice it is undiversified. In its instrument choice, it risks a poor performance by buying expensive liquidity insurance that a long-term fund does not require. (It is interesting that the amount of financial risk should depend on the purpose and not on the people, institutions or instruments. Today, regulators too often ignore investment purpose in order to treat everyone the same. They focus instead on approving people, instruments and institutions [8].)

Pension funds with long-term liabilities, such as paying out an income in twenty years time, have the capacity to earn the liquidity premium on investments today because they do not require daily liquidity. The most appropriate and safest instruments for a long-term investor are those that offer a liquidity premium, but where the credit risk is low, or can be effectively diversified. This looks like a portfolio of public and private equities, emerging markets, and infrastructure investments where credit risks can be hedged out through diversification or in the currency derivatives markets.

There are some interesting wider economic issues here. If one third of emerging market central bank reserves were managed for future generations rather than for liquidity purposes, this could unleash around $800bn of investment for infrastructure and equity in emerging markets [9]. This kind of investment spending is likely to have a greater multiplier on global economic growth than increased consumption at home. Another issue is that if dollar borrowers face a declining flow of undiscerning capital merely in search of liquidity, and an increasing flow of capital looking for good long-term investments, it would improve investment discipline in the US and elsewhere thereby reducing the scope for speculative bubbles.

The public sector can mimic the way private long-term savings institutions might invest by establishing a different benchmark for that proportion of their assets that is not required for liquidity purposes, and is instead being invested by the State, as a custodian for future generations. Investment bankers would salivate at the prospect of bidding for the mandate to manage these assets. I recognize that salivating investment bankers is not a pretty sight but is not necessarily a bad thing.

Of course, investment banks are enormously incentivised to convince State sponsors to let them manage these assets in a similar way to which they mange the assets of their other investors. Indeed many central banks have been convinced by investment banks to "go down the credit curve" when they have explained that they no longer need so much liquidity, as opposed to what they should be doing which is going down the "liquidity curve" without sacrificing credit quality. Indeed, private sector asset management tends to be more short-term and liquidity focused than always makes sense from an economic point of view. The reasons for this are many. It may be peer pressure, inappropriate regulation or where financial innovation is immature, the simple liquidity constraints that many individuals face. Few private investors are as long-term an investor as the State can be. Consequently while the State can outsource the management of assets to the private sector if it wishes, it is critical that the authorities carefully consider and own the investment benchmark. To focus the mind of central bankers on this issue it should be pointed out that if the investment benchmark being managed is common to those already being managed in the private sector then not just the management but the ownership of the assets could be privatized. It may help in following this Future Generations investment benchmark if the State kept some assets managed in-house thereby supporting skills transfer and keeping a watchful eye on the external managers performance. They should also hold on to the option to bring the assets back in-house if they are performing better there.

A Better Outcome For All, Without The Blackmail

The political temptation in some countries would be to invest some of this money at home or in regional groupings. Geographical constraints make no investment sense and there are serious financial and governance problems in spending foreign exchange reserves on domestic projects. It is important to remember that foreign exchange reserves are not free assets but come with an external liability. It would be very poor risk management to match that external liability with an illiquid, local asset. It is better to maximize the wealth of future generations by earning the short-run liquidity and market premia while hedging out credit risk, wherever those assets may be. This diversity would improve the safety of the investment portfolio - as well as returning investment discipline to dollar borrowers.

If central banks with reserves larger than their liquidity requirements changed their investment benchmarks so that they acted more like long-term investors, global imbalances would be of the same size, but dollar borrowers would face greater investment discipline; emerging market savers would get better returns; many emerging economies would receive more growth-promoting infrastructure investment and more long-term, stable, capital flows. What in that picture would we object to?

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1 Fellow, Gresham College; President, Intelligence Capital Limited, a financial advisory boutique; Co-Chair, OECD Emerging Markets Network, and Visiting Fellow, CERF, Cambridge. The author is grateful to Hans Genberg, Robert McCauley and Richard Portes for helpful discussions on these matters.

2 See Treasury Papers of John Maynard Keynes. Public Record Office Class T 247 – Papers relating to International Finance and the Chancellor of the Exchequer’s Consultative Committee, 1940-1946).

3 The Schumer, Graham Bill in the US Congress directs the White House to impose a 27.5% tariff on Chinese products outside the WTO process unless Beijing agrees to a substantial revaluation of the renimbi.

4 According to CNN’s US election coverage, Ward 62 is one of the most marginal electoral wards, in one of the most marginal districts, of a marginal state.

5 The term was coined in 1977 by the Economist to describe the decline in the manufacturing sector in the Netherlands after the discovery of natural gas in the 1960s. The classic economic model was developed by W. Max Corden and J. Peter Neary. See, Corden W.M., Neary J.P. (1982). "Booming Sector and De-industrialisation in a Small Open Economy." The Economic Journal 92 (December): 829-831.

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