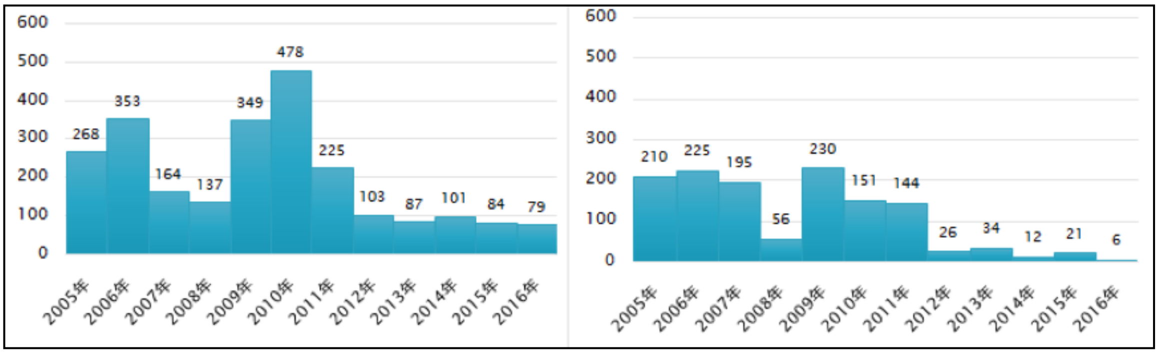
10th Anniversary of Financial Crisis:

Does Global Imbalance Equate to Current Account Imbalances?

Qiao Yide: We need to comprehensively and accurately interpret the global imbalance, and to simply equate global imbalance with current account imbalances may lead to policy dislocation and public opinion deviations.

Updated at 06:42 on September 5, 2017, wrote for FT by Qiao Yide, Deputy Chairman and Secretary General of Shanghai Development Research Foundation.

You may remember that a period of time before and after the financial crisis ten years ago, the term "Global Imbalance" was repeated in high frequency in the economic media. The chart below is the occurrence frequency of this term in English and Chinese media summed up by factiva. Obviously, the occurrence frequency of this term has reached a high point and then declined sharply in recent years. But with the emergence of anti-globalization trend, it may probably rise again since this year.



Occurrence frequency of the news keyword Global Imbalance over the years (2469 times)

Occurrence frequency of the news keyword"全球不平衡"over the years (1324 times)

Chart 1: Occurrence Frequency of the News Keyword Global Imbalance Over the Years

So, what is global imbalance? It is said that it is the global current-account imbalances or global trade imbalances; in particular, it is "large deficits in one country, with counterpart surpluses being concentrated in a few others "(Rato, 2005). We do not show any doubt as to such a statement, and almost all of us equate global imbalance with current-account imbalances. I have been very confused in this regard; does globalization or the global economic structure also include investment and financing? Why do we only focus on trade imbalances? It's a pity that I have never seen an article or a speech answering this question positively. There are, of course, countless articles describing the negative effects even the global financial crisis led by trade imbalances. The logic is that emerging market countries, especially China, are investing heavily in American capital markets because of the trade surplus, driving down interest rates in the US, and eventually causing the global financial crisis. According to the argument of Bernanke, former Federal Reserve Chairman," I will argue that over the past decade a combination of diverse forces has created a significant increase in the global supply of saving--a global saving glut--which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today.". Stanley Fischer, FED Vice Chairman, made a speech at the end of July, although he also spoke of that "A country's economic development will spillover to other countries through trade, capital flows and prices (including interest rates and exchange rates)", he has mentioned capital flows, but it was a pity that he finally returned to the trade issue, and thought that the spillover effect can be described as the current account balances, but did not make any explanation.

There is also a different voice to the assertion with a clear omission, even though the voice is weak. Hyun Song Shin, Chief Economist of BIS and Claudio Borio, Director of Monetary and Economic Department believe that the main reason for the US subprime bubble is the spread of global banking industry, other than the so-called "global savings glut" mainly featured by the Sino US trade imbalance. Before the financial crisis in 2008, the current account between Europe and the US was basically balanced, but European multinational banks borrowed a great deal of dollars from the US money market through their branches in the US, repatriating back to Europe; at the same time, the purchase of a large number of structured products in the US market formed huge cross-border capital flow, coupled with the implementation of long-term low interest rate policy by the Federal Reserve released a lot of liquidity, resulting in excessive prosperity before the crisis. I agree with their basic point of view. It is unreasonable and inaccurate to simply equate global imbalance with current account imbalances. The reasons are as follows:

Firstly, the total amount of cross-border capital flows is huge, and finance has shown its unique law. In the process of economic integration, the initial cross-border finance was carried out along with cross-border trade. By the 70s and 80s of last century, with the global manufacturing layout of multinational companies, FDI emerged. After the 80sof last century, the Bretton Woods system collapsed, and the US dollar become the global credit currency; major countries began to relax control on capital accounts, thus leading to cross-border capital flows such as hedging, securities investment, derivatives investment, etc. to increase sharply. According to the shadow banking monitoring report released by FSB, in 2015, the size of shadow banking has reached 34.2 trillion US dollars, accounting for 69% of GDP in the monitored countries, while the size of global OTC derivatives market stock reached 494 trillion US dollars, about 6.6 times the global GDP of that year. Quite a bit of them are cross-border transactions. As you can see from Chart 2, the total amount of cross-border capital flows in G4 countries has far exceeded the current account balances. And finance is increasingly showing its unique law; according to an annual report released by the

Bank for International Settlements in 2014, the business cycle in the US generally lasts for 1-8 years, while the financial cycle lasts for 15-20 years.

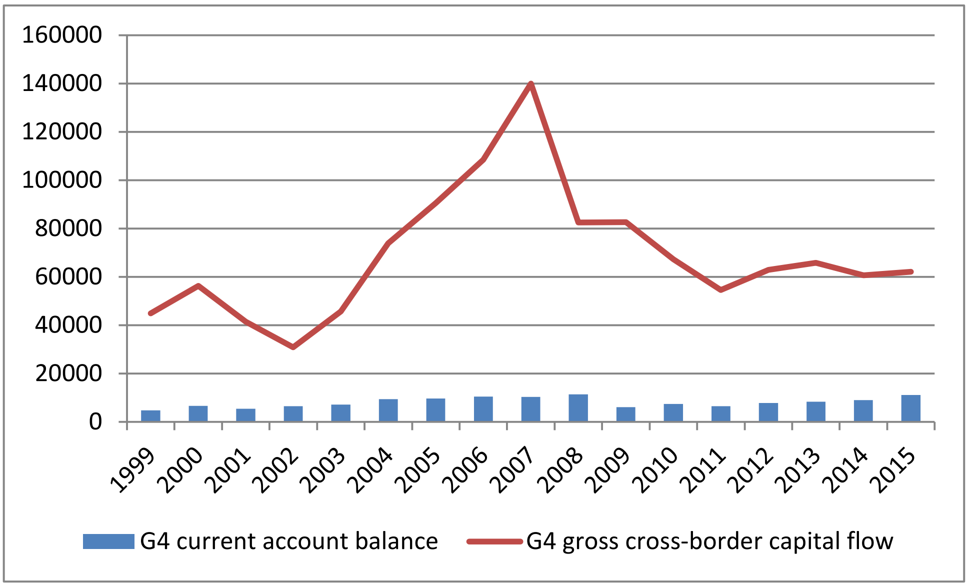


Chart 2: Comparison of G4Current Account Balances and the Total Amount of Cross-Border Capital Flows (in 100 million US dollars)

Source of the chart: World Bank, IMF, Shanghai Development Research Foundation

Secondly, the indicator indicating global current account imbalances - the current account balance is a net amount. It is a summary of the volume of import and export trade over a period of time. Many details are concealed in simple positive and negative offset, so it cannot really describe the cross-border flow of capital accompanying trade. For example, an amount of money flows out from a country at the beginning of the year, and the same amount of money flows in to it at the end of the year; from the annual net amount, it is equal to 0, but whether the inflow or outflow, if the amount is huge, will have a great impact on the country's exchange rate, interest rate and other macroeconomic variables, and then affect the global financial stability.

Thirdly, cross-border funds are highly concentrated in a small number of hedge funds and large asset management companies; it is easier to impact on the market. At present, the total amount of assets managed by global asset management companies has reached 107% of the world's GDP, 578% of the total amount of global cross-border capital flows. Moreover, the capital managed by the world's top 45 asset management companies accounts for 64% of the total capital.

Finally, cross-border capital flows have higher volatility, higher speed and greater impact. The inflow and outflow of capital through trade are limited by real trade and relatively stable; while other short-term capital is more influenced by earnings expectations and risk preferences, the inflow and outflow are more frequent. That is to say, the volatility of cross-border capital flows is far greater than that of the current account balances (see Chart 3).

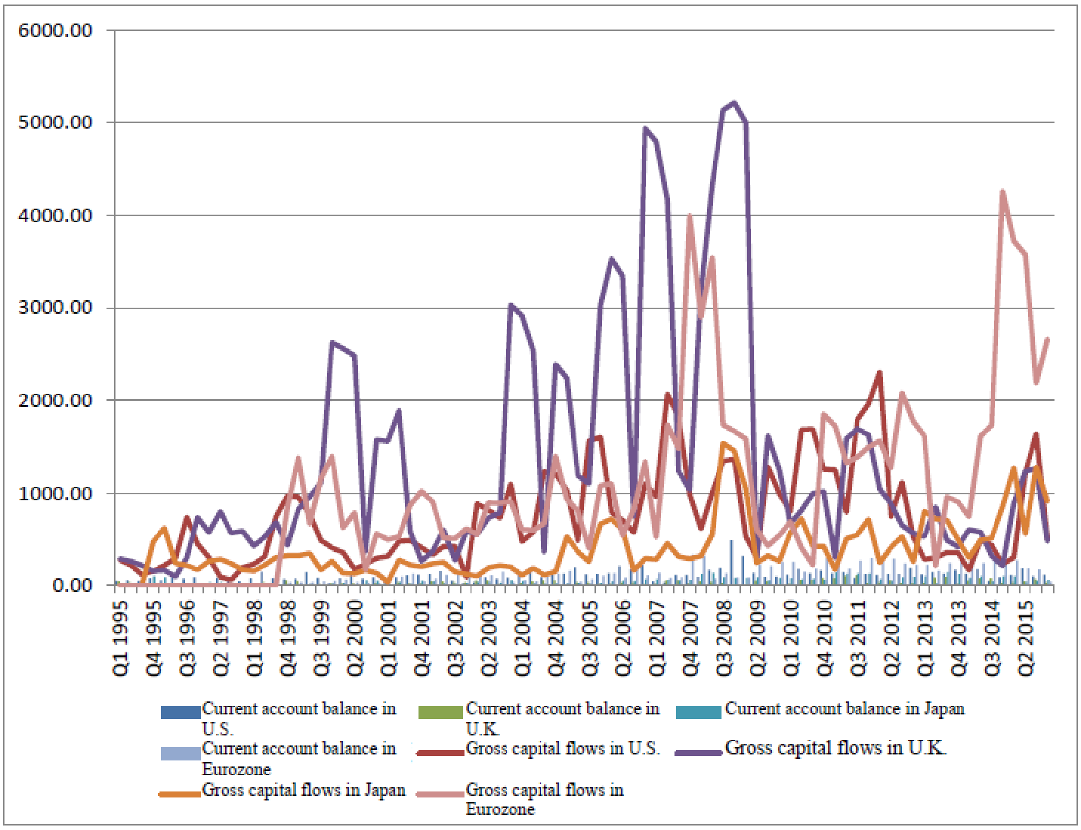


Chart 3: Total Amount of Cross-Border Capital Flows and Volatility of Current Account Balances in the US, Euro Area, UK and Japan

Source of the chart: World Bank, IMF, Shanghai Development Research Foundation

To equate the global imbalance with current account imbalances has a clear policy implication, which focuses on surplus countries and requires them to make adjustments. Similarly, that I am not in favor of equating the global imbalance with current account imbalances also has clear policy implication, namely, we can not only focus on the trade level, but also issues on the financial level. A recent McKinsey report pointed out that the total amount of cross-border capital flows during the financial crisis was 3 times that of today. Such huge cross-border capital flows were one of the causes of the global financial crisis.

In the interpretation of the report on August 22, Shawn Donnan from "Financial Times" pointed that " In a world where US President Donald Trump and other economic nationalists are threatening to erect new barriers to trade, debates about globalisation today are dominated by the surge in the trade of goods over the past half-century and its impact on societies. It is that goods trade that most economists cite when they express fear that the march towards greater economic integration might now be in reverse. Less is said about the flow of capital or the state of financial globalisation. Yet the excesses of capital flows were one of the main causes of the financial crisis — and are where the next crisis might lie. “There is no clearer view than this passage concerning the current public opinion deviation due to inaccuracies in theory.

Obviously, firstly, for the current global economic growth and stability, it is one-sided to talk about trade without finance. That means as to resolving bilateral trade issues, in addition to the negotiations on specific issues, we should also pay attention to global issues, especially the negotiations with the US, we cannot be led, cannot talk about trade only, but get out to see the finance. It should be noted that the US not only has a trade deficit with China, but also has a trade deficit with more than 100 countries worldwide. That means, the US trade deficit is not a bilateral problem. The reason is that it is closely related to the low savings rate in the US and the dollar's dominant position in the international monetary system. The savings rate in the US has been prolonged, sustained to be depressed, and investment gaps, requiring the replenishment of external funding. The dollar's dominant position is a double-edged sword, which makes that the FED's monetary policy can almost not be affected by external factors, with certain control power over the cost of foreign debt, and makes that the US enjoys seignior age; but at the same time, it also limits the structure adjustment in the US. The dollar's dominant position requires the US to provide liquidity to the world, so it is inevitable to make the US trade deficit in the long run. Since the collapse of the Bretton Woods system in the 70s and 80s of the last century, the US dollar has become the global credit currency, and the US current account has continued to suffer deficits. When the resource-rich countries enjoy the high surplus brought by them, their economic structure is single and difficult to adjust. This phenomenon is often called as a "resource curse". By contrast, this predicament in which the US is now may also be called as the "US dollar curse".

Secondly, as mentioned earlier, a substantial increase in cross-border capital is one of the causes of the global financial crisis, and therefore cross-border capital must be highly concerned about. Although the total amount of cross-border capital flows greatly contracts than that before the crisis, new features of "one decrease one increase "appeared in the direction of flow and structure respectively. In the direction of flow, capital flows between developed countries mainly decreases, and the cross-border capital flows of emerging market countries have increased greatly, and exceeded the peak before the crisis. Zhou Xiaochuan, Governor of China's Central Bank, has divided cross-border capital into two categories: investment and speculation. Now, the investment cross-border capital is decreasing, while speculative cross-border capital is increasing, and some of it even uses FDI as a cover. Therefore, after the global financial crisis, the open attitude of international economics circles to capital accounts directly related to cross-border capital flow has been changed significantly, from the attitude of opening the more the better in the past, to that capital control remains a policy tool of prudent macroeconomic management now, the opening of capital accounts requires a combination with domestic financial market development and the degree of maturity of each country, to open prudently and appropriately, step by step; another factor related to cross-border capital flows is the exchange rate. A few years ago, Rey, professor of economics at the London Business School, submitted a famous paper “Dilemma not Trilemma: The global financial cycle and monetary policy independence” in the Jackson Hall conference; she thought that the floating exchange rate did not play a role basically, and the countries were either more or less manipulated by the FED’s monetary policy, or had to impose capital controls. Recently, Mr Obstfeld, Director of the IMF’s Research Department, et al. conducted a study, and demonstrated that the floating exchange rate system still played a positive role in resisting financial fragility through the data of 43 emerging countries from 1986 to 2013. In a word, now the attitude of international economics circles to the exchange rate system is not so fixed but there is some basic consensus still, that the floating exchange rate is still effective under normal circumstances, and it will play a role in smoothing cross-border capital fluctuations; but in major financial crisis or the existence of large-scale capital flow fluctuations, the exchange rate’s effect will be weakened, even disappear.

Hereby I highlight the possible consequences of global financial imbalances, and that does not mean that I deny the negative effects caused by trade imbalances. I do think that a long-term, sustained and great trade imbalances (surplus or deficit) of a great power not only means that problems exist in the country's economic structure, but also it will bring difficulties to other countries to adjust international balance of payments. However, it is important to emphasize that I do not agree to simply equate global imbalance with current account imbalances, and I oppose the resulting policy dislocation and public opinion deviations. In a word, I think that the 10th anniversary of the global financial crisis is the right time to comprehensively and accurately interpret the global imbalance.

(Note: This article represents the author's point of view only. The main points in this article are derived from the research report of Shanghai Development Research Foundation "Global Financial Imbalance: Implications, Impacts and Countermeasures" led by the author)