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Downside risks from financial shocks will persist unless global imbalances are effectively addressed

The financial market turmoil of the late summer may be a fading memory, as stock markets hit new highs and borrowers regain access to credit markets, but the imbalances they exposed continue to loom large over global economic prospects. What was highlighted by that turmoil was not simply the fragile state of the sub-prime mortgage market in the United States but a steep build up of debt by United States households, which has been allowed to continue for far too long. With house and stock prices rising at a record pace, debt-led consumer demand in the United States and export-led growth in much of the rest of the world have combined to give a fast pace of overall global growth, but this has been accompanied by large and persistent current account deficits (United States) and surpluses (Japan, oil exporters and parts of emerging Asia). Such has, in essence, been the configuration of global macro-financial imbalances. Talk of an "end of business cycles", the "goldilocks economy" and overall "sound fundamentals" convinced lenders, borrowers and policy-makers that there was little danger of a sudden reversal of rising asset prices and the possible danger of a disruptive unwinding of the global imbalances.

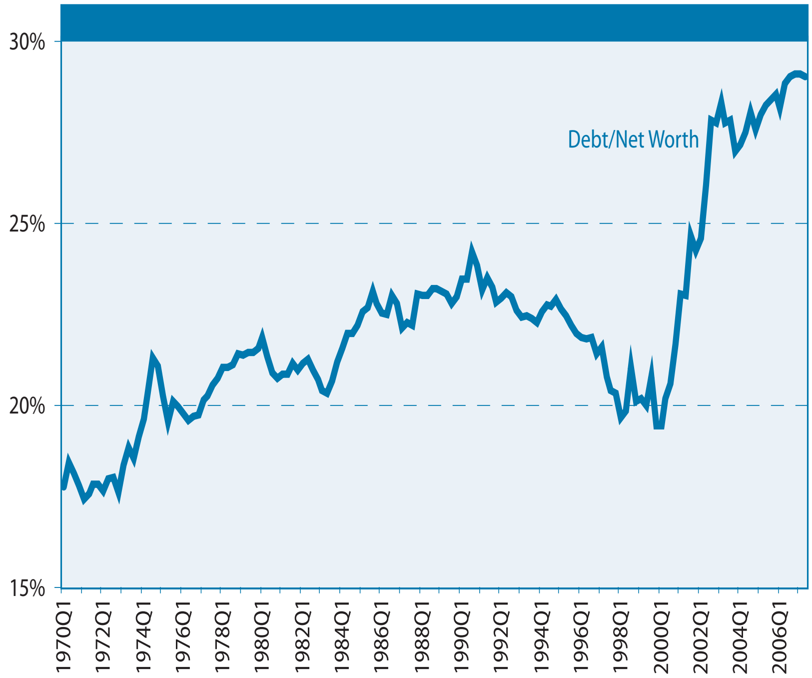
The immediate response of central banks to the turmoil unleashed by the sub-prime crisis has been to inject new liquidity into the financial system and, at least in the United States, to lower interest rates. These measures seem to have succeeded in calming financial markets. However, continuing along this path hinges on a recovery in asset prices and reigniting the lending spurt that had previously kept the United States and the world economy growing. This carries the danger of reproducing an asset price bubble and widening imbalances even further. Policy makers should now urgently shift attention to the more strategic problem of global imbalances which requires collective action to rebalance global demand over the long run, secured through a negotiated, multilateral compact.

Debt of United States households becomes a global problem

Back in January, the UN's World Economic Situation and Prospects 2007 (http://www.un.org/esa/policy/wess/wesp.html) highlighted the downside risks for the world economy from a steeper fall of United States house prices. While no one can know with real certainty how far house prices might fall or for how long, policy makers need to honestly confront downside risks. First, there is the ongoing hit to the construction sector which has already affected growth performance in the United States. Second, there is the effect on the financial conditions of the households, and hence, on their ability to borrow and spend. Figure 1, representing the debt to net worth ratio of the household sector, hints at the potential damage that could come through this channel. During the 1990s, and until the stock market crash of 2001, households sustained the expansion of the United States economy by borrowing on the expectation of rising asset values in their balance sheets (equities and houses) and an improving debt/net worth position. The process came to a halt with the crash in equity markets.

Following the 'dot.com' crash in early 2001, the direction of the ratio of debt to net worth was reversed, rising at a record pace from 20 to 27.5 per cent in only two years. It would have been much worse had house prices fallen at that time. That did not happen in large part thanks to the looser monetary policies adopted by the U.S. Federal Reserve in response to the stock market correction, driving short-term real interest rates down to zero. A severe recession was avoided thanks to continued consumer spending as households borrowed against the rising value of houses and the subsequent recovery in stock prices. The worrisome prognosis now is that falling house prices and increased risk aversion on the part of financial institutions could cause a tightening of lending conditions, sluggish domestic expenditure in the United

Figure 1
Debt to net worth of the household sector in the United States



Source: Federal Reserve Bank, Flow of Funds, Tables D3 and B.100.

States, weaker export demand in the rest of the world and, eventually, a weakening of global economic activity.

From sub-prime worries to prime concerns

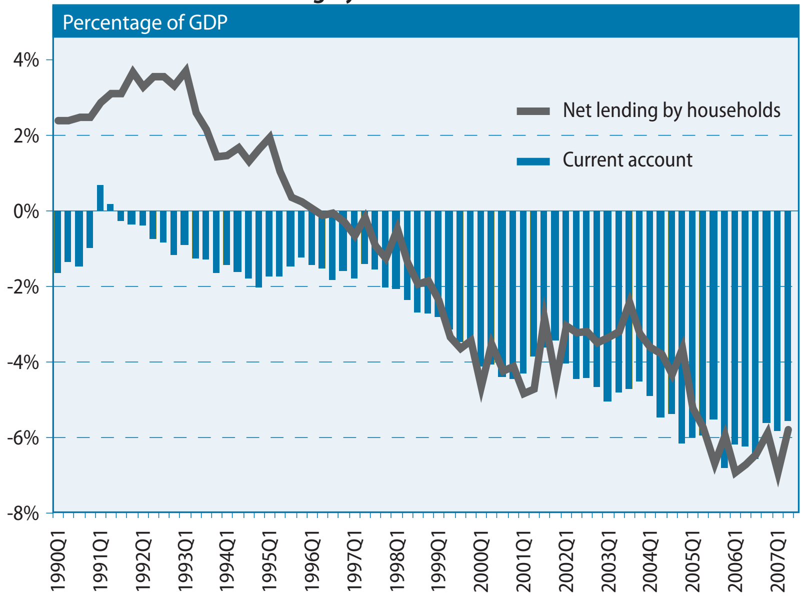
Many commentators, in the United States and elsewhere, believe that such a gloomy scenario is improbable, pointing to the resilience of the financial sector in avoiding a credit crunch and the strength of new global growth engines from the developing world. But there is a real risk of misplaced confidence. In the United States, even assuming the sub-prime meltdown has run its course, there is little likelihood of lending regaining the pace experienced in recent years unless there is a new surge in asset prices. But this raises the question of just how much more debt, currently equal to 166 per cent of disposable personal income, households could (and should) actually carry. Answers should recognise that sub-prime mortgage lending is only the most extreme manifestation of a wider destabilising trend, being more detached from prospective income streams and even more dependent on the belief that house prices would keep rising so that even low-income borrowers could postpone mortgage repayments by drawing equity from their re-priced homes.

For the rest of the world, the obvious questions are just how dependent growth has been on the debt fuelled United States economy, and which countries, and under what conditions, could take up the slack from a slowdown in the major economy. A global rebalancing will not happen unless it results from a decisively concerted commitment of policy-makers around the globe.

Just how vulnerable the rest of the world is remains uncertain. According to estimates by UN-DESA, a sharper drop in United States housing sales and prices (respectively by, 16 and 10 per cent during 2007) could knock as much as 2 percentage points of growth of the United States economy and 1.3 percentage points from world economic growth, with growth in developing countries likely hit by as much as 1.6 percentage points after spillovers have run their course.

Against this backdrop, policy makers should realize that the fundamental problems to address are the persistence of extraordinary deficits of United States households, mirrored in the current account deficit, and counterpart surpluses in Japan, Germany, oil exporters and parts of emerging Asia (see Figures 2 and 3).

Figure 2
United States: Net lending by households and current account balance



Sources: Bureau of Economic Analysis: National Income and Production Accounts, Sept. 2007. Tables 2.1 and 5.1.

Global reflation is needed, but who will lead?

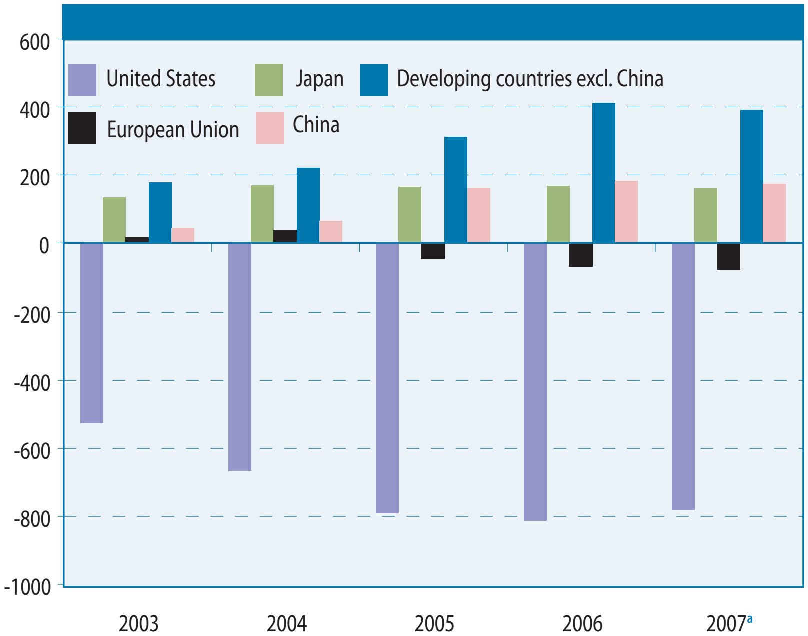
Some commentators still argue that the best chance of the United States economy, and with it the world economy, regaining a degree of balance is to allow the market mechanism to re-price risk, adjust exchange rates and weed out irresponsible investors. The decisiveness with which central bankers reacted to the crisis is a clear sign that financial markets cannot be left to their own device and that some form of intervention is necessary. But to spare the world economy from a succession of similar crises, equally decisive action is needed by policy makers to correct the global imbalances.

A global contraction, triggered by a tight reining in of domestic spending in the United States is one way out, but this is neither what the United States or the rest of the world would hope for. Equally disruptive would be a large and rapid devaluation of the dollar. The alternative is a long- term strategy of re-switching the impetus of global demand growth to surplus economies, mixed with a rebalancing in the United States, from household consumption to business and infrastructural investment. Making use of the increasingly pronounced cross-country effects of national policies in a coordinated manner carries the potential to improve the stability and efficiency of the global economy. But working in this direction will require an international financial architecture that is supportive of growth and employment.

Given the size of the global imbalances and the accumulated liability positions, a gradual approach to global adjustment may be preferable in that it avoids shocking the economy with a large change in fiscal, monetary and exchange rate policies all at once. Such a gradual approach likely will be more reassuring to financial markets. But this will require continued commitment for a prolonged period to a cooperative policy agreement of all major players. This in turn will require a credible mediator and multi-year agreements on policy adjustments.

Mediating the required processes of multilateral surveillance and macroeconomic policy coordination is unlikely to work when doubts exist about the impartiality of the mediator. There is no alternative agency available to the IMF to act as a mediator to these processes. But the voice and voting power in the IMF currently lacks sufficient representation from developing countries, despite their growing importance in the world economy. An effective governance reform of the IMF is therefore urgently needed as a pre-condition for a coordinated policy solution.

Figure 3
External balances and imbalances: Selected countries



Source: United Nations World Economic Situation and Prospects 2007, Update as per mid-May 2007 (http://www.un.org/esa/policy/wess/wesp2007files/wespupdate2007.pdf).
a Forecast.

Further, investors and financial markets will only be reassured if the commitment to continued adjustment is credible. A small down payment on adjustment may not do much to reduce financial vulnerabilities if the markets doubt that governments will follow up with additional instalments. If a government is unconvinced of the need for adjustment, it may agree to token adjustments to get off the hook with its foreign partners with no intention of following up subsequently. A partial solution would be to publish a multi-year schedule for adjustment. Announcing specific targets, in the form of a schedule, and then missing them has costs in terms of reputation. So does specifying a series of policy actions and then failing to implement them. Commitments in order to be credible must be attainable and readily monitored, which requires that they should be explicit, measurable and public. One can imagine similar multi-year schedules emanating from the IMF's consultations. The "deliverable" from the consultations process (the "multilateral letter of intent") should be a sequence of policy adjustments tied to a specific schedule, to be made public at the end of the multilateral round.

In the longer run, only deeper and more far-reaching reforms will be able to prevent a similar constellation of imbalances from arising again. This may involve a further scaling-up of SDRs in a redesigned global reserve system. But a broad consensus on the challenges posed by global imbalances will only happen through an open dialogue and sharing of information among all stakeholders, when there is an avoidance of finger pointing and where the surveillance of actions and adjudication of disputes is impartial. Clearly, in all these respects, the pace of governance reforms needs to accelerate sharply.

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