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GLOBAL IMBALANCES: A NEGLECTED ISSUE IN THE US FINANCIAL CRISIS

What to Except from the New US Administration #2

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The US financial crisis, ignited by the subprime mortgage problems, has finally led to the collapses of major US financial institutions, with the resulting credit crunch further slowing the real economy. Behind this debacle, there is the problem of "global imbalances" long left unaddressed by the US government.

Global imbalances refer to the asymmetries in international finance caused by the way the large current account deficit of the United States is being financed by booming Asian and oil-rich economies. The fact that the US dollar is an international currency provides the United States with a special privilege: to offset its current account deficit, Washington can borrow foreign money in its own currency without worrying about exchange risk. The US current account deficit, continuously accumulated since the 1980s, currently stands at US$800 billion a year. This approximately corresponds to 6 percent of the country's gross domestic product (GDP). With both households and the federal government in the red, the US is the world's largest debtor economy, run on money borrowed from the rest of the world.

Of course, concerns are arising over the sustainability of this approach. The 1985 Plaza Accord, which brought about massive currency adjustments, was reached at the initiative of a United States concerned about its accumulating current account deficit. Since then, however, the US government has never seriously addressed the issue of global imbalances. This gave rise to optimistic opinions among experts as recently as the beginning of last year: some argued that foreign countries have no option but to invest their dollar reserves, accumulated as a result of trade surpluses, in US bonds and stocks; others argued that a new regime had been created where US deficits were automatically financed by surplus economies in a manner satisfactory for both the US and these economies. Then emerged the subprime loan problem that developed into the financial crisis today.

Some experts blame global imbalances on excessive savings in Asia, not the US debtor economy (or a shortage of US savings), with Ben Bernanke, the current Federal Reserve chairman, being among them. He argued in 2005 that "excessive" global savings were the main culprit of the US current account deficit. It cannot be denied that failure to face up to the real problem contributed to the housing bubble and the subsequent subprime loan crisis. Bernanke's predecessor, Alan Greenspan, also praised subprime lending practices as a system allowing low-income house buyers to borrow money in April 2005 when the subprime bubble was already inflating.

The Black Monday stock market crash in 1987, the 1997 Asian financial crisis that led to the Russian default and the collapse of one of the largest US hedge funds, and the subprime loan crisis that started in 2007 – all of these occurred against a backdrop of growing global imbalances. It is only a coincidence that these major financial crises have happened every ten years. What is important is the backdrop. Although the current account deficit of the United States has swollen to about 6 percent of its GDP, compared with about 3 percent of GDP at the time of the Plaza Accord, there have been virtually no measures taken and few discussions held on tackling this problem in the United States.

As a result of continuing to cover expanding current account deficits by borrowing money abroad, the net external debt of the United States reached US$3.2 trillion as of the end of 2007. This accounts for 23 percent of the US' GDP. All this was borrowed in US dollars, the US' own currency, thanks to the prerogative mentioned above, with exchange risks borne by foreign lenders. Alarmed by their ever-increasing dollar assets, these lending countries naturally started to reduce the ratio of dollar deposits in their foreign reserves.

Under these circumstances, a large adjustment of the dollar exchange rate, or a dollar meltdown, could happen anytime. Such is the danger of global imbalances. Nonetheless, the United States averts its attention from this problem, prompting calls to sell off the dollar even among the oil-rich Gulf states.

Global imbalances are also a problem of excessive dollar supplies around the globe as a result of the unaddressed US current account deficit along with massive budget deficits. Excessive dollars can disturb the market as speculative money. Herein lies the cause of the instability in financial and exchange markets. It is very ironic that US financial institutions have difficulty offering dollar-denominated financing amid a financial crisis that started in their country. This suggests how serious the subprime loan problem is. In the long run, however, Washington must realize that the problem of global imbalances stems from the structural problems within its own country and present the world with constructive means of tackling this problem.

At the beginning of September, the US Congressional Budget Office

(CBO) released figures indicating that the budget deficit of the federal government would reach a record US$438 billion in fiscal year 2009 (starting in October 2008). The US government has already decided to bail out financial institutions with taxpayers' money. Far from reducing the "twin deficits," this measure will exacerbate the problem, widening global imbalances and intensifying potential structural instability in global markets.

Viewed from a long-term perspective, the US dollar may have entered a phase in which it is gradually stepping down as the world's key currency. Accordingly, the privileges accorded to the United States due to this status will be undermined. No single currency, including the euro, can replace the US dollar at the moment, however, so for the time being, we may witness a transition period in which the international currency system is sustained by more than one currency.

This transition period will be a tough one that will not end easily. The United States must reduce the excess debts in the household sector accumulated during the housing bubble expansion. This will result in a long-term reduction in consumer spending and, helped by the weak dollar, a decrease in the trade deficit. In the meantime, it is important for the US' trade partners, including Japan, to slow or reduce exports to the United States. Japan must supplement US adjustment efforts by continuously expanding domestic demand. In order to do so, Japan must review and reform various regulations that have constrained growth. In this sense, proceeding with structural reform will not only help Japan but will also contribute to relieving global imbalances. A thorough debate on the system and policy to come is needed.

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