Overview Panel

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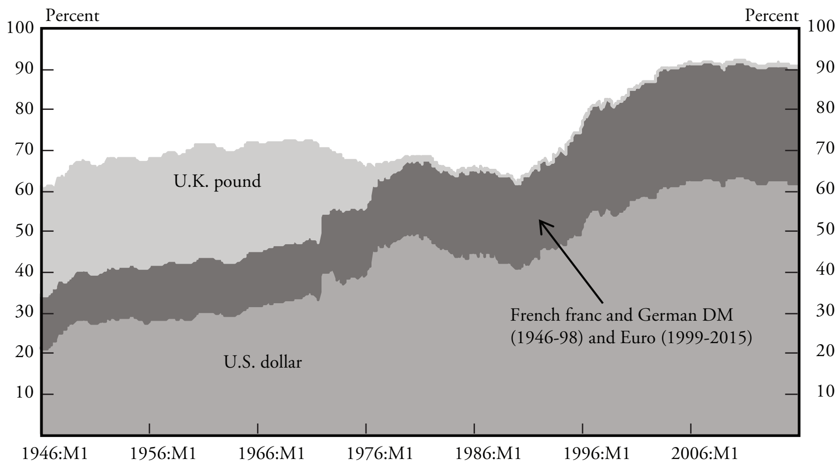
As the last speaker on the last panel, I feel it incumbent on me to review some of what we heard over these two remarkable days, focusing on what received shorter shrift. Firstly, we have discussed the global economy without talking about fluctuations of exchange rates. Notably, the silence about the significant swing in the dollar exchange rate since 2014 was deafening. I want to build upon Kristin Forbes' observation from yesterday that we need to put on the table what this implies for monetary policy. Secondly, I will return to some of the topics of the previous session on global imbalances and capital flows. My focus, though, will not be on North-South flows as in that discussion, but on North-North flows (if you can call periphery Europe the North) in terms of intra-European transfers and South-South flows in terms of lending from China to other emerging market economies. There have been significant developments on both fronts. Thirdly, I will connect some of the discussion that we heard from Alan Auerbach and Yuriy Gorodnichenko today on debt and monetary policy. That is my road map.

Let me start with the near term, or a much shorter horizon than what Tim Kehoe has just presented. Between mid-2014 and late 2016, there was a significant and sustained appreciation of the foreign exchange value of the dollar. One has to wonder whether the positive economic surprises from Europe and Japan owe to the effects of easing financial conditions there, beyond quantitative easing, which is the flip side of a stronger dollar. If so, we also have to wonder whether the subsequent reversal in the dollar since the beginning of the year might threaten those recoveries. Take this in the context of the discussion of risks in the euro area by Mario Draghi yesterday. If the economic recovery in the euro area is shorter lived or shallower than we can hope for, there would be direct implications for the speed of normalization of monetary policy. A point I repeat in my recent commentary is that stabilization after a crisis should not be equated with crisis resolution.[1] As I will focus on when I talk about debt and intra-European capital flow, we are perhaps seeing stabilization from a protracted period of contraction followed by very sluggish growth, rather than outright resolution. Remember, in a different context, when we look back at the "lost decade" of the debt crisis of Latin American, not every quarter or every year was lost. Rather, there were significant recoveries in Brazil, Argentina and Mexico that proved shallow and short-lived. One can only hope that that is not what's going on now in the context of Japan and Europe, but time will tell. But at any rate, expect that the recent reversal in the dollar to take some steam from those recoveries.

Turning to the emerging markets, in recent work that Ethan Ilzetzki, Ken Rogoff and I have done, we find that the dollar still serves as anchor for about a little more than 60 percent of the approximately 200 countries in our sample (as shown in Chart 1).[2] As a consequence, dollar fluctuations have had—and will continue to have—significant effects. To put the currency fluctuations in the context of emerging markets, those economies enjoyed a capital flow bonanza from 2003-13 that came to an end. Once commodity prices declined and the dollar strengthened, the situation turned problematic for two reasons. First, in addition to the collapsing commodity prices, many emerging markets have dollar denominated debts and a stronger dollar means a higher debt servicing burden. Second, many emerging markets also shadow the monetary policy of the Federal Reserve to limit the fluctuations of their currencies vis-à-vis the dollar, limiting their ability to act to counter the cycle. It remains to be seen, as I said, whether the recent reversal will make fortunes slightly

Chart 1
Post-World War II Major Anchor Currencies
Share of Countries, 1946-2015, Excludes Freely Falling Cases



Note: Freely falling refers to cases where the annual inflation rate equals or exceeds 40 percent.
Source: Ilzetzki, Reinhart and Rogoff (2017)

easier for emerging markets and somewhat more difficult for Japan and Europe.

Turning to capital flows, I want to compliment some of the discussion that understandably focused on the largest imbalance, the one involving China and the United States, because it had a decided North-South flavor. But Maury Obstfeld also mentioned the rising imbalances in Germany. And in that context, I am surprised to have been at a conference filled with central bankers and not heard anyone mention Target2 balances. This is definitely an area where we have had considerable action recently. Just to provide perspective on these Target2 balances, which reflect the intra-European or intra-euro zone capital flows, Germany has a surplus in their reserve account equivalent to 23 percent of German GDP, Greece and Portugal's Target2 balances are about 40 percent of their respective GDP's, Italy's is over 20 percent of its GDP and Spain's is close to 30 percent of GDP (Table 1). Let me put it differently. Those are capital flows out of these countries into Germany. Alan Auerbach rightly emphasized the important of including contingent liabilities in the form of pensions and other entitlement when understanding debt burdens. But

Table 1
Target2 Balances as a Percent of GDP
(Selected Countries, as of June 2017)

Country	*Balance*
Germany	23
Greece	-40
Italy	-21
Portugal	-38
Spain	-28

Source: European Central Bank.

I would add that an element not brought into the discussion of debt is central bank debt. Target2 balances are an external liability of the central bank and in orders of magnitude that are meaningful. Therefore, when we consider public sector debt, rather than general government debt, for Italy, Spain, Portugal, or Greece, those substantial Target2 balances have to be added to that picture. These balances are not irreversible, of course. A dramatic reversal in Target2 balances occurred for Ireland, which now has a small surplus when once the cumulative outflows amounted to 60 percent of GDP in the worse moments of the crisis. There was also a dramatic reversal for Cyprus. But for Greece, Italy, Portugal and Spain, we have yet to see any turn around. Rather, there has been considerable widening. I will return to this issue when I discuss what some of the possible implications could be for monetary policy.

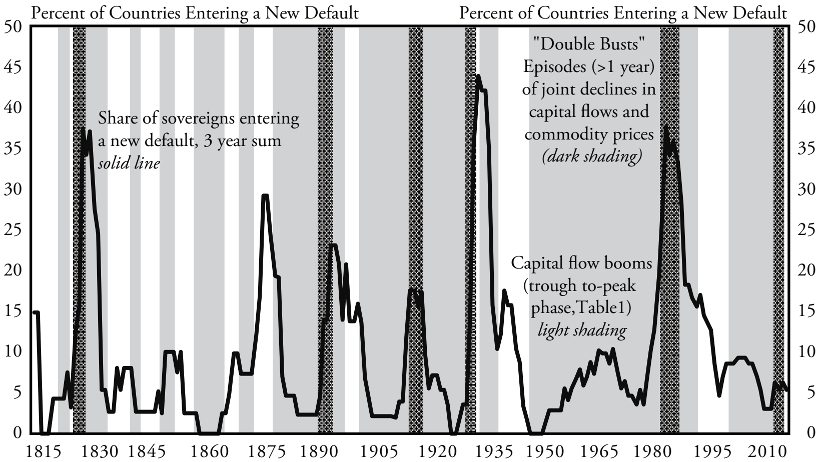
Turning to intra-EM capital flows, I think one story that merits more discussion is that during the bonanza era in commodity prices, 2003 to 2013, there was a significant expansion in Chinese capital flows to emerging markets, especially to commodity producers. The data are difficult to come by, but direct lending from China to other emerging markets was sizable. While it might not have been quite so significant from the vantage point of the massive Chinese economy, it was certainly very material for many of the capital flow recipients. So, among the reversals in capital flows that matters is this slowdown of direct lending. Maury Obstfeld expressed some skepticism that the current imbalances will disappear. I share that view that the largest imbalances are not likely to change dramatically anytime soon.

However, in the context of some of the emerging markets that have received little discussion in this conference, the capital flow drainage associated with declining commodity prices and associated with China's less aggressive external lending policy is a very real issue.

I don't want to end the capital flow discussion on a negative tone. I think that there is actual room for satisfaction on how the global economy has weathered the recent reversal in capital flows. Emerging markets, in general, withstood a major reversal in flows, a large decline in commodity prices, and a slowdown in China. Based on work that I have done with Vincent Reinhart and Christoph Trebesch (2016) in which we look at capital flow cycles since the early 1800s, this would be the first time that we've seen such a drastic reversal without a surge in sovereign defaults (Chart 2). Now, part of that good news may be that the emerging markets have managed the bonanza in capital flows better. But part of that may be that world interest rates remain very low. And part of that may be that there are hidden defaults because there is considerable official lending to low-income countries that is in arrears.

To conclude, let me turn now to the issue of what all this implies for monetary policy. And my emphasis here is twofold. We cannot overestimate the pressure felt on monetary policy in the decade after the crisis. Central bankers really bore the brunt of stimulating growth for much of the period because fiscal space is limited in so many countries. I do not see those burdens diminishing anytime in the foreseeable future. As a result, normalization is likely to be much slower in the foreseeable future than any historical context. Alan Auerbach emphasized in his presentation the very high levels of fiscal indebtedness and the very high level of contingent liabilities in pension funds. We were there before. At the end of World War II, public debt was even higher in the advanced economies than it is today. However, private debt was really not the issue then that it is now. It is a particularly big issue also in Japan. It is a particularly big issue in the context of European banking. And, it is a big issue for the United States. When Chairman Paul Volcker tightened monetary policy in October 1979, household debt in the United States was approximately half of what it is today.

Chart 2
Capital Flow Booms, Double Busts, and New Sovereign Defaults, 1815-2015



Notes: Pale shaded areas denote global capital flow bonanzas. Dark shaded areas denote episodes of "double busts."
Sources: Reinhart, Reinhart and Trebesch (2016) and Online Data Appendix.

Central banks will go slow. In Japan, I think the start of normalization is in a very indefinite future. In Europe, given what I see as still some very serious North-South imbalances and continued banking issues in an unresolved legacy loan issues, it is still far off. Even in the United States, where those issues perhaps are not nearly as pressing, high levels of indebtedness are going to act as a constraint on the speed of normalization. Much as after World War II, sustained negative real interest rates are a way of liquidating debts. Of course, after World War II, debt stocks ran off also because we did not continue to add to the debt through fiscal deficits. So, again, I would like to highlight that the debt dynamics that we have at present—both public and private and external and domestic—are very different from anything seen in the past.

One last point. As Menzie Chinn highlighted during the discussion of official flows, much of sovereign debt is in the hands of central banks all over the world. Indeed, the level of official intervention in debt markets puts us in new territory. One consequence is that interest rates may not as useful as a signal of vulnerability as was once the case. We may be less able to see the bad event before it directly confronts us.

Endnotes

[1]See Reinhart (2017).

[2]Ilzeztki, Reinhart and Rogoff (2017).

References

Ilzetzki, Ethan, Carmen M. Reinhart and Kenneth Rogoff. 2017. "Exchange Arrangements Entering the 21st Century: Which Anchor Will Hold?" National Bureau of Economic Research 23134, February. *http://www.nber.org/papers/w23134.*

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