

## **External Adjustment and the Global Crisis**

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The period preceding the global financial crisis that began in 2008 was characterized by widening current account imbalances across the globe. With the crisis, these imbalances declined significantly. In particular, a turnaround in private capital flows has forced several countries to seek official external assistance and the banking systems of the periphery of the euro area to rely on liquidity flows from the European Central Bank.

**Lane** and **Milesi-Ferretti** analyze the external adjustment process following the financial crisis. Their hypothesis is that pre-crisis current account imbalances widened beyond levels consistent with sustainable medium-term positions. The emergence of large imbalances was facilitated by a benign global financial environment, with low risk aversion among lenders and borrowers coupled with over-optimistic expectations about future growth in deficit countries and amplification mechanisms associated with rising housing and financial asset prices in recipient countries. After this rapid expansion in external liabilities, external conditions changed drastically during the crisis, triggering a painful process of current account adjustment.

In the empirical analysis, the authors first seek to establish the extent to which current account balances prior to the crisis exceeded levels consistent with underlying economic fundamentals. They next ask whether the current account adjustment following the crisis was sharper in countries where pre-crisis “excesses” were more evident. The answer to this second question is a resounding “yes”—countries whose

current account balances were in excess of what could be explained by standard economic fundamentals prior to the crisis also experienced the largest contractions in their external balance.

The researchers subsequently examine how external adjustment has taken place. Has the adjustment in deficit countries been facilitated by real exchange rate depreciation, facilitating export growth and a reallocation of resources towards the tradable goods sector? Or, have deficits declined primarily because of a sharp compression in domestic demand? Has the adjustment experience differed between countries with fixed versus flexible exchange rate regimes? The evidence suggests that the adjustment in deficit countries took place primarily through a compression of output and demand: that is, expenditure reduction, rather than expenditure switching. In fact, real effective exchange rates in countries with fixed exchange rates moved in a destabilizing direction—with real appreciation in countries with excess deficits—while for countries with more flexible regimes exchange rate movements were only weakly tied to pre-crisis current account balances.

Finally, they turn to a closer examination of the behavior of capital flows during this period, asking two questions. First, what types of flows were associated with changes in current account balances? Second, what role was played by official flows (including automatic flows among member central banks within the euro area) in the adjustment process? The authors find that in countries with exchange rate pegs, the turnaround in the current account is more strongly related to the initial current account gap than in other countries, and that it took place primarily through a dramatic shift in other investment flows, which include most banking flows. They also find some

suggestive evidence that the scale of current account adjustment in countries with a pegged exchange rate has been cushioned by official capital flows—IMF and EU loans but importantly ECB liquidity funds compensated for the exit of private capital flows from major deficit countries.

The high output costs that have been associated with rapidly correcting a large current account deficit during this episode are a strong motivation for research that assesses the extent to which widening current account deficits during good times might partly reflect distortions and thus raise vulnerabilities to shifts in investor sentiment (a “sudden stop”). In turn, the design of optimal policy interventions in such cases is a further item for the future research agenda.

A related issue is the extent to which the correction in current account balances seen in the last few years will persist. The crisis has led to a significant downward revision in potential output in several deficit countries, suggesting that pre-crisis imbalances in deficit countries may have reflected “overheating” at least to some extent. Nevertheless, to the extent that the current account correction in deficit countries was caused by an “undershooting” of output and demand (and therefore reflects negative output gaps), some of the decline in “excess deficits” (and symmetrically of surpluses) could prove to be temporary, unless exchange rates adjust so as to encourage a rebalancing towards domestic demand in surplus countries and external demand in deficit countries. Another possibility is that countries with high external liabilities may face persistent external financing constraints—in this case, if price and exchange rate rigidities prevent the needed adjustment in international relative prices, output may remain below potential for much longer.