Vienna, 18-19/1/06

Eurogroup 50

A few thoughts on Global balances

Jacques de LAROSIÈRE,
Member of the French Moral and Political Science Academy

The world global financial imbalances can be summarized in the following way :

1. a strong GDP growth in the US coupled with large current account deficits ;
2. subdued economic growth in Europe -hindered by insufficient structural reforms- and a balanced position in terms of current accounts ;
3. a spectacular economic expansion in East Asia coupled with high current account surpluses and growing international reserve accumulation.

o0o

The following table gives a summary of present current account imbalances as they stem from major areas :

Billions of US dollars	2004	2005 (estimates)	2006 (forecasts)
USA	- 668	- 759	- 805
Euro-area	+ 46	+ 23	+ 18
Japan	+ 172	+ 153	+ 140
Asia (developing) (of which China)	+ 93 (+ 68)	+ 109 (+ 115)	+ 113 (+ 121)
Middle East	+ 102	+ 217	+ 272
Russia	+ 60	+ 101	+ 119

Source : IMF, World Economic Outlook, September 2005.

o0o

Let me venture a few ideas on how that highly contrasted picture can be explained and possibly improved.

o0o

I. A strong GDP growth in the US coupled with growing current account deficits :

1. There is a tendency among some economists and more widely within the circle of American policy makers, to consider that imbalances in the US current account are a **consequence** of external factors and therefore do not need to be tackled by the US authorities. Since there is, according to this view, a "global savings glut" in the rest of the world, let the "excess savers" deal with it.

In the same vein, some are tempted to say : "As long as productivity growth is strong and healthy, as long as inflation is contained and as long as the US GDP grows in line with its potential (around 3,5 %), nothing is to be worried about. Any restrictive policy action by the US would only (other things being equal) reduce global growth and damage not only the US but also the other countries that are taking advantage of the strong domestic demand in the US".

And they add that if the US continue to attract -primarily in the form of the acquisition by foreigners of US Treasury instruments- the necessary inflows of capital to finance their external deficit (around 6 % of GDP), it is because foreign investors are willing to do so in view of the good performance of the US economy and of US assets.

2. For sure, the US current account deficit is partly a result of faster growth of domestic demand in the US than in the Euro area, in Japan and in a number of emerging countries. But it is also true that the causes of US external imbalances are due to a large extent to negative **domestic** factors.

- The US fiscal deficit is a case in point. General government fiscal imbalances have hovered around - 4 % of GDP per year since 2002[1]. Given the dramatic decrease in savings by households, these fiscal deficits only compound the current account problems.

  So it would be desirable that the US government starts reining in its fiscal imbalances.

[1] Against an average of 2,7 % in the Euro zone.

- But the major factor at play results from the insufficiency of household savings in the US.

  The fact that US household savings are now negative, has to do with domestic causes :

- the accommodative monetary policy over the years that has led to low borrowing interest rates ;
- the high liquidity and the bubble in asset prices with its wealth effects ;
- the ability of the US households to leverage and "extract cash" out of housing wealth through using property as collateral or through extended and renegotiated loans.

  - Additionally, the notion that foreign investors are "attracted" by higher yields on US assets than those they can expect in the rest of the world, is a misconception. Recent studies show that US investments abroad have, over the last fifteen years, yielded significantly more returns than those earned by foreigners who have assets in the US[2].
  - One sometimes argues that the growing deficit in the trade of goods in the US will -because of high spending on R&D and efficient corporate innovation- be offset in part by the surplus in services. But this is not the case. The US surplus of services with the rest of the world is declining and is very small in comparison with the deficit in goods (the services surplus has declined to 0,5 % of GDP)[3].
  - Finally, it is not sure that a significant increase in domestic demand in Japan, Europe and the Asian economies, would necessarily lead to a rebalancing of the US trade account. Indeed, the US industrial manufacturing production has been very rigid since the mid-90's and has not reacted much to increases in domestic demand. How would it react to increases in external domestic demand -barring extreme movements in exchange rates which would have themselves negative effects on the world economy- ? The answer is not obvious. It may well be that an increase in domestic demand in China, for example, would be met by Chinese production and not by US exports, given the over-investment and the low costs of the Chinese economy.

[2] See : Philip Lane and Gian Maria Milesi-Ferretti : "Examining Global Imbalances" by (Vienna – Eurogroup 50 – January 2006). See also Patrick Artus, Banque de France, Symposium – November 4, 2005. See also Chart I annexed.

[3] See : Patrick Artus mentioned above.

II. Subdued economic growth in Europe -hindered by insufficient structural reforms- and a balanced position in terms of current balance of payments :

1. Firstly, one has to observe **that there is no "excess" savings in Europe** contrary to some uninformed views.

The Euro area current account is in global balance : according to ECB statistics, from 2000 to 2004 the cumulated surplus over those five years amounted only to 13 Billion euros (i.e. 2,6 Billion a year on average).

This trend has continued in 2005[4]. In total, if one looks at gross savings related to GDP, the Euro area in 2004 was at 20 % which is equal to gross fixed capital formation (in the US, figures show a 6 % deficit and in Japan a 2,5 % surplus)[5]. International reserves of the Euro area have remained stable over the past three years at around 300 Billion euros.

So there is no overall "savings glut" in Europe.

2. Secondly, **the composition of savings and dissavings is different in Europe** from the situation in the US.

- Indeed, **household savings in Europe have remained positive** at their historical levels (gross savings ratios to disposable income have hovered around 14 % over the last 6 years) while net household debt has remained stable.

- The **corporate sector is almost in balance** (9 % gross savings to GDP versus gross fixed capital formation of around 10 %), but, given improved profits, corporate indebtedness has significantly reduced over the last 4 years.

- Lastly, **the public finances of the Euro zone are in bad shape** : continued deficits (close to or higher than 3 %) high debt ratios to GDP (71 % average).

So, the problem is not in the household nor in the corporate sector, but in inadequate fiscal policies.

---

[4] Actually, there has been a deficit of – 7,8 BN euros in the first three quarters of 2005 due, in particular, to Spain and France current account deterioration (ECB – Statistics).

[5] 2004 : US gross savings : 13,8 % of GDP ; gross fixed capital formation : 20,1 %.
Japan gross savings : 26,3 % of GDP ; gross fixed capital formation : 23,9 %.
Source :ECB

3. Thirdly, **most European countries have not indulged in the housing leverage mechanisms that have so powerfully boosted consumption in the US.**

Residential investment in Europe has not grown as fast as in the US over the last years.

This can be explained, in part, by very different housing financing mechanisms that characterize most European countries. For example :

- the possibilities to renegotiate conditions after rate decreases are lesser than in the US ;
- the possibility to "extract cash" out of housing wealth is not a continental European practice.

Therefore Europe has not "benefited" (if one can say !) from the residential wealth engine that has boosted consumption in the US.

4. What should Europe do to answer the question regarding the external responses to a rebalancing of savings in the US ?

I shall focus on the following points.

➢ **First, the things Europe should NOT do** :

- European countries should not increase their fiscal deficits to boost demand. The debt ratios are so high and the future consequences of aging population on social and health care systems are such that any relaxation of fiscal policies would be harmful. On the contrary, it is essential for long term growth to regain budgetary discipline through expenditure reductions ;
- European countries should not try to match the financial devices that allow households to extract cash from house price increases. The overextended position of US households is, to a large extent, a systemic weakness and continental Europe is, in this regard, in a more "normal" or "neutral" position, even if low interest rates (as they are now) provide a permanent temptation to get into more debt.

➢ **The things Europe should be doing** :

- **reforming their ailing health care and pension systems ;**
- **opening up and liberalizing their labour and goods and services markets which are much too rigid ;**

- **extending working hours to boost output and increase durably potential growth** (which has been revised downward to 2 %).
  Some steps have been recently taken in these directions by European Governments (public sector pensions, labour market flexibility, overhaul of public debt and fiscal expenditure…) but they need to be continued and reinforced ;
- finally, **energy conservation** is also a structural obligation for all countries. In this respect, the nuclear energy policy that France engaged in, more than thirty years ago, has produced remarkable results (75 % of electricity consumption in France comes from nuclear plants) and has lessened its oil dependency.

o0o

In sum, structural reforms are a precondition to enhance the growth potential and the resiliency of European economies even if their short term impact on global imbalances is difficult to assess.

Basically[6], an increase in the productivity of the European Union would help to adjust the US current account deficit in as much as it were to occur in the non tradable sector (productivity increases in the tradable sector could improve EU's trade accounts).

o0o

III. A spectacular economic expansion in East Asia coupled with high current account surpluses and growing international reserve accumulation :

As Prof. Yung Chul Park has stated in a recent paper[7] : " At the end of September 2005, a total of reserves held by 10 East Asian economies[8] stood at $ 2,485 Billion up from a little over 1 Trillion five years earlier". China counts for close to $ 800 Billion out of that total. This reserve increase has been the result of current account surpluses as well as of growing capital inflows coupled with heavy exchange rate intervention to stabilize Asian currencies.

1. **The case of Japan** and its relations with the other Asian countries is important to analyze :

[6] See : OECD 2004 – Obstfeld and Rogoff : "The Unsustainable US Current Account Position Revisited", Working Paper 10869. See also : Josef Christl : "Global Imbalances and Regional Monetary Cooperation", Vienna, Eurogroup 50, January 2006.
[7] "Global Imbalances and East Asia's Policy Adjustments", Eurogroup 50, Vienna, January 2006.
[8] China, Japan, Korea, Taiwan, Hong Kong, Indonesia, Malaysia, Philippine, Singapore and Thailand.

Japan's current account surplus is among the largest in the world (153 Billion in 2005) and amounts to 42 % of the total current account surpluses of the Ten East Asian Economies listed above.

But Japan's trade surplus with the US has "only" amounted to 68 Billion US dollars in 2005 (i.e. 28,8 % of the total bilateral trade balance of the Ten East Asian Economies with the US). China, on the other hand -although it has a significantly smaller global current account surplus (115 Billion in 2005) than Japan-, has a much larger bilateral trade surplus with the US : 166 Billion i.e. close to 50 % of the total of the Ten East Asian Economies.

This explains the intensity of US political reactions to the Chinese exchange rate policy and the American protectionist temptations that should not be under estimated.

One also has to observe that Japan has been running surpluses in its trade with all the Ten Asian Economies including China. This situation has been accompanied by a depreciation (in real effective terms) of 15 % of the Yen over the three years period beginning in 2003[9], which compounds exchange rate policy difficulties in other East Asian economies.

So, a move towards reviving domestic demand in Japan appears essential. "Unless Japan is prepared to absorb more goods and services not only from the US but also from other East Asian countries, the external pressure on the rest of East Asia to expand domestic demand will not be headed". (Pr. Park)

2. **<u>The case of China is dominated by structural issues</u>** :

China's National Savings amount to 51 % of GDP and are expected to increase further.

Is this situation -very high savings, current account surpluses and huge reserve accumulation- durable ?

Not in the long term. But in spite of the importance of defining in general terms the appropriate objectives (i.e. shifting demand in China to domestic consumption, letting more flexibility in the exchange rate, liberalizing services….), it seems more pertinent to look into the complexities of the situation and to take into account the structural aspect of issues. I shall give a few examples :

[9] See : Prof. Yung Chul Park above.

- if savings are high in a country like China, it is in part because of the deficiencies of social safety nets and retirement schemes which raises an important challenge for the authorities ;
- if flexibility of the exchange rate is desirable, stability and strengthening of the financial system is also of the essence. These two objectives are closely interrelated. But at the present moment, too rapid a move toward exchange rate flexibility could compound the problems of the financial sector ;
- the expansionary monetary policy in China (fuelled by heavy exchange rate interventions) tends to favour lending at regulated low interest rates which is mainly directed to existing companies in particular state owned. This compounds the difficulty of financing new, know how and services oriented enterprises and thus tends to weaken productivity growth, to encourage over-investment and to increase production and the need to export ;
- therefore, a more market driven monetary policy, more flexible interest rates and efficient banks have a crucial role to play in intermediating the substantial savings towards productive investments and services ;
- underemployment of significant parts of the rural population remains a pressing concern "as the economy adjusts to the effects of state-owned enterprises reforms and WTO accession[10]".

Thus, one can stress that managing successfully China's long term growth and encouraging its gradual integration in the global economy, requires a number of structural changes that will take time.

o0o

Raghuman Rajan, economic counsellor and Director of the Research Department at the IMF[11] has remarkably summarized the issue of global imbalances : "Some have suggested the world has a saving glut. In fact, the world is investing too little… investments have fallen off sharply since then with only very cautious recovery.

"The policy response to the slowdown in investments has differed considerably across countries. In the industrial countries, accommodative policies such as expansionary budgets and low interest rates have led to consumption or credit-fuelled growth, particularly in the Anglo-Saxon economies. Government savings have fallen especially in the US and Japan and household savings have virtually disappeared in some countries with housing booms…

[10] "China's growth and integration in to the world economy", IMF, Occasional Paper 232, 2004.
[11] « The Age », Melbourne, September 2005, quoted by Bob Solomon in his : International Economic Letter, dated November 17, 2005.

"We should celebrate the implicit global policy coordination that enables the world to weather this crisis… Now, (things) need to be reversed. It is misleading to term this situation as a savings glut for that would imply that countries running current account surpluses should reduce domestic incentives to save. But if the true problem is investment restraint… the world needs two kinds of transitions. First, consumption has to give way smoothly to investment, as past excess capacity is worked off and as expansionary policies in industrial countries return to normal. Second, to reduce the current account imbalances that have built up, demand has to shift from countries with deficits to countries with surpluses".

Therefore, multiple and complex policy actions are now called for in all parts of the world[12]. If they are carried out (some have already been engaged) and if governments are seen as seriously integrating these multifaceted objectives in their own policies, the outcome could be a gradual reduction of present imbalances and vulnerabilities. Such a change in the present trends would help markets to adjust smoothly. Otherwise, developments could be uncertain, precipitous and damaging to all.

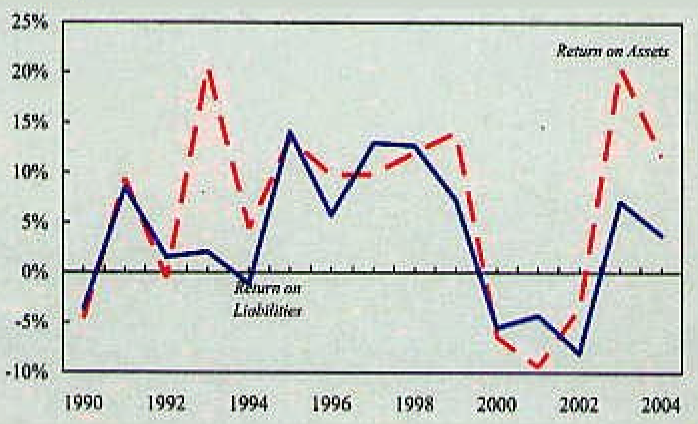
[12] Including in the Middle East where much of the large current surpluses should be channelled into major investment projects notably in the energy sector.

chart I

Better return

U.S. investors have earned from their external assets than foreign

United States: Real ates of Return on externel Asstes and Liabilit
(percent)



Source: Lane and Milesi-Ferretti (2005b)