Global and intra-European imbalances: Causes and implications

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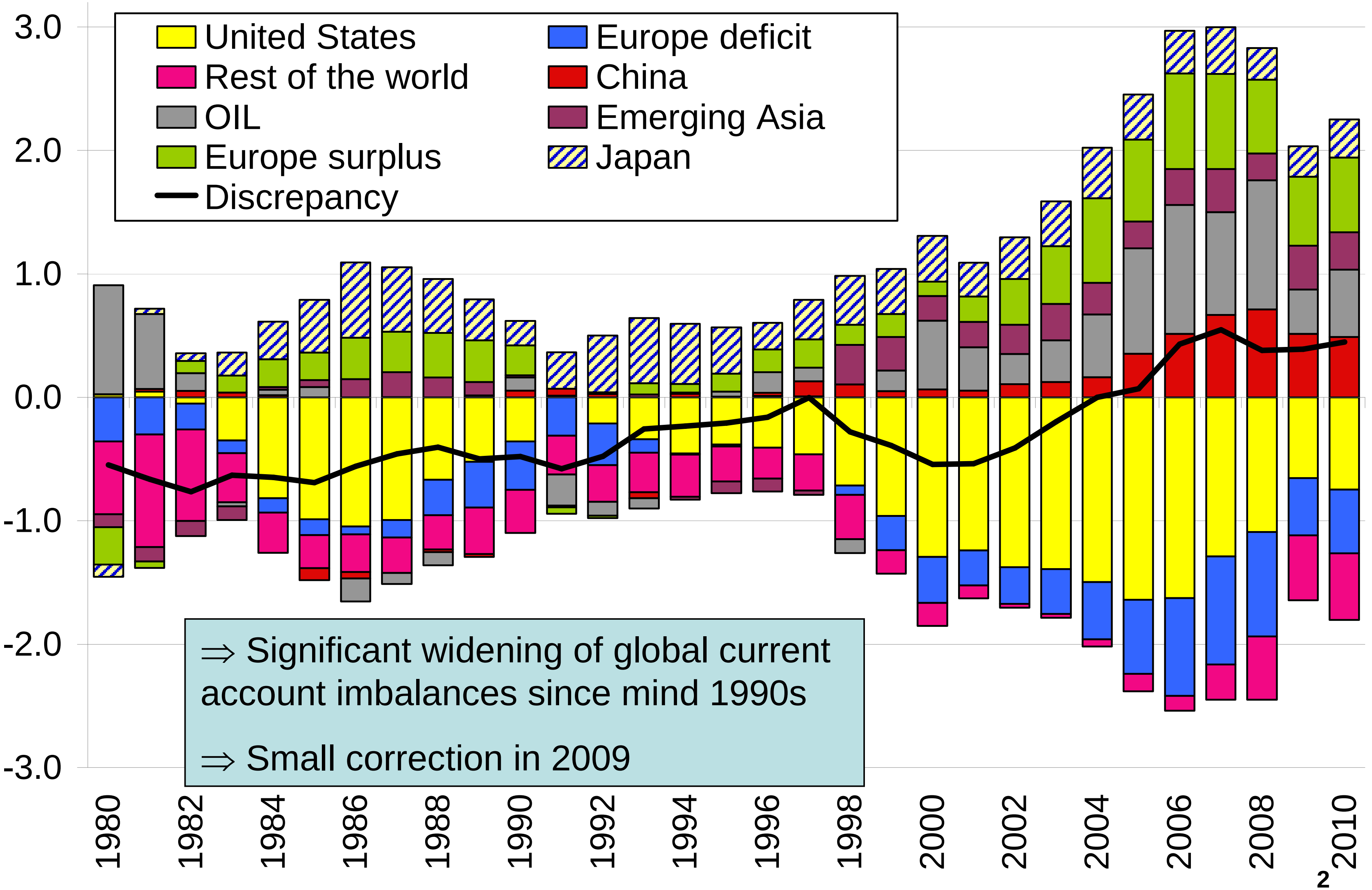
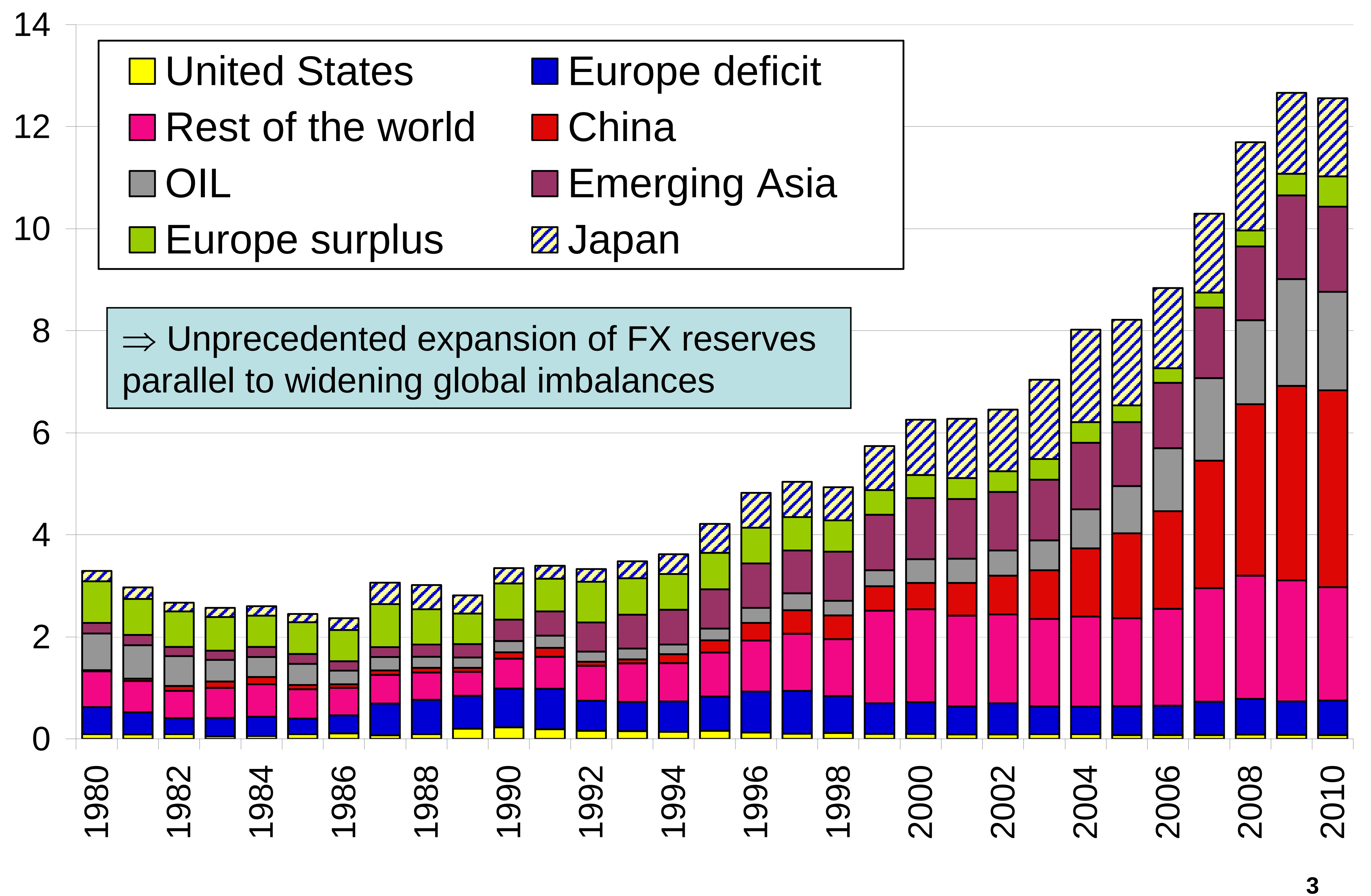
Global current account balances (% World GDP)



Source: Author's calculations based on IMF World Economic Outlook April 2011

Foreign exchange reserves (% World GDP)



Source: Author’s calculations based on data from IMF International Financial Statistics

Global imbalances: multiple causes

- **Current account surpluses in emerging countries:**
  - Intertemporal consumption smoothing (eg saving oil revenues)
  - Self-insurance against crises
  - Export-led growth strategies
  - Insufficient or inadequate social safety nets
  - Underdeveloped or inefficient financial markets
  - Political motives

- **Current account surpluses in major countries (e.g. Japan, Germany):**
  - Decade-long near-stagnation of domestic demand
  - Aging

Global imbalances: multiple causes, cont’d

- **Current account deficit in the US:**
  - Lax monetary policy, asset-price inflation, consumption boom
  - “Global savings glut”
- **Current account deficits in European periphery:**
  - Better utilization of savings in an integrated Europe
  - Loss of competitiveness
  - Housing bubbles and consumption booms
- **Listed causes suggest that there are both ‘good’ and ‘bad’ reasons for imbalances**
- **Many of the factors are interrelated**
  - E.g. rapid growth in China $\rightarrow$ oil prices $\rightarrow$ import bill of commodity importers and revenue of exporters $\rightarrow$ fall in interest rates $\rightarrow$ unsustainable booms

Role of global imbalances in the crisis

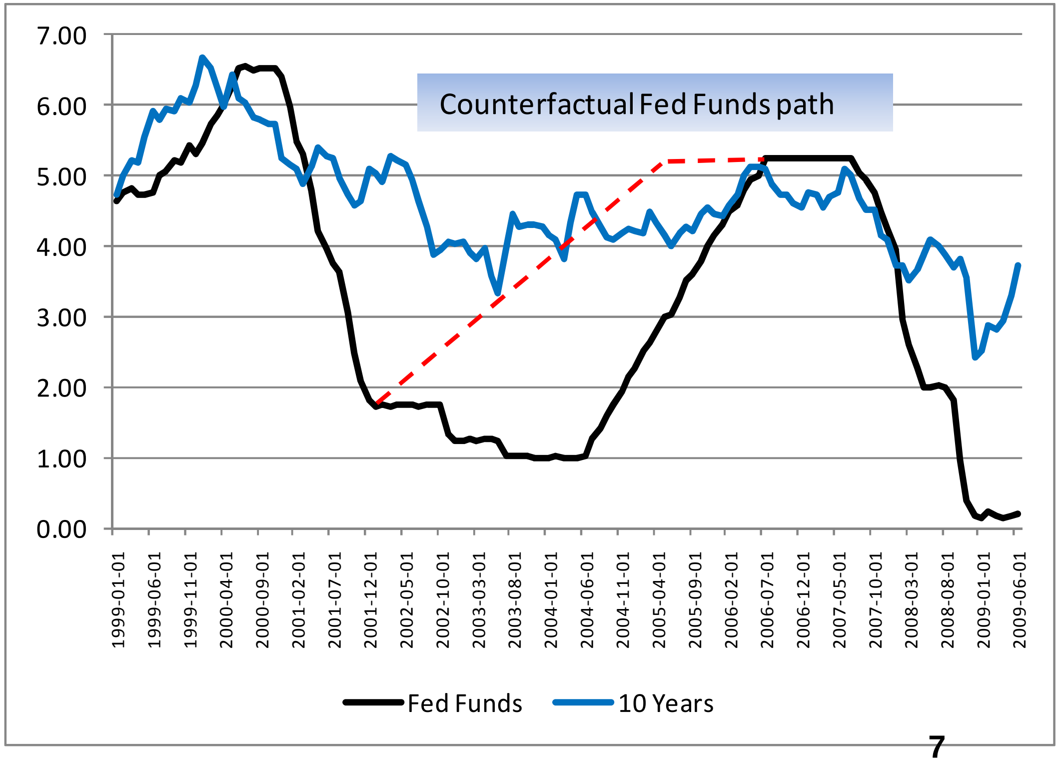
- "*At the core of the crisis lay an interplay between macro-imbalances which had grown rapidly in the last ten years, and financial market developments and innovations*" (Turner Review, Financial Services Authority (2009))

- Trigger of the crisis: *<u>not</u>* the forced correction of large current account imbalances, but failures within the financial system

- Yet global imbalances *<u>indirectly</u>* caused the crisis by contributing to failures within the financial system via lowering interest rates, contributing to the growth of leverage, and leading to an excessive volume of financial intermediation

Role of global imbalances in the crisis, cont'd

- Causes of the crisis: Micro and macro factors
- With higher interest rates, housing booms, stock market valuations, and the rise in private debt would certainly not have reached the same levels
- What created this macroeconomic environment?
  - Failure of monetary policy?
  - Or the broader saving-investment balance at global level?
- 'Taylor rule': the Fed would have tightened faster after the 2001 recession (see chart)



Role of global imbalances in the crisis, cont'd

- There was low inflation in the US: central bank credibility, structural changes, and the increase in the global labour force
- A central bank dedicated to price stability had therefore little reason to raise interest rates aggressively enough to prick the real-estate bubble
- Whether the Fed should have raised interest rates in the name of financial stability?
- From 2001 long-term interest rates remained remarkably stable at a low level
- Role of global imbalances: massive inflow of foreign savings into the US lowering long term interest rates
- Look for higher-yield, but ”safe” assets: manufacture securities with AAA status but with higher returns

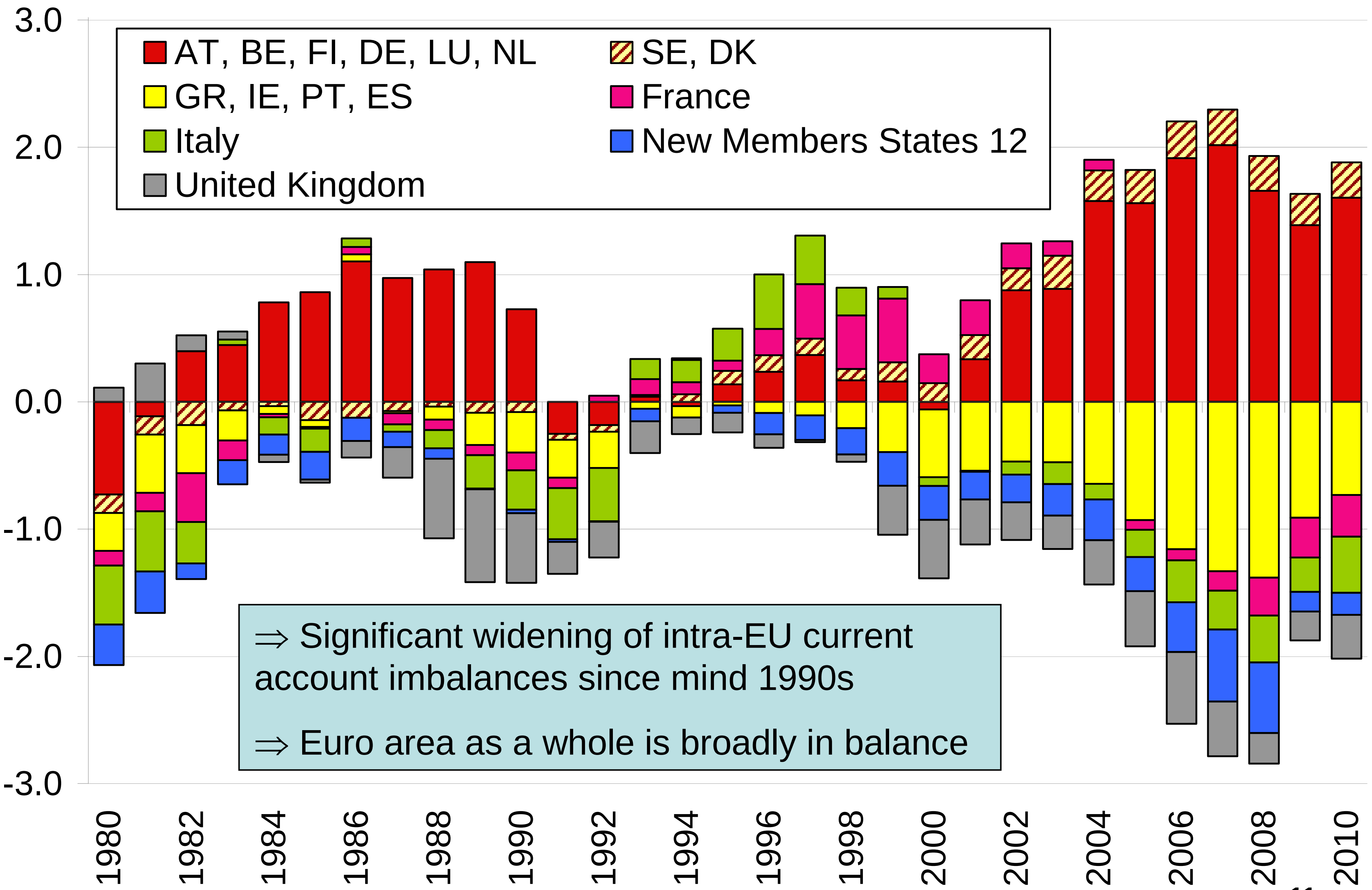
Long term consequences of continued global imbalances

- Continued reserve accumulation (in which the US dollar has a crucial role): more and more dollars are held outside the US
- Potential for a new crisis. Some possible mechanisms
  - inflow of foreign savings into the US continues to lower long term interest rates → replication of unsustainable situations
  - concerns over US fiscal sustainability
  - concerns over US external debt sustainability
  - fiscal capacity of the US will decline with the decline of the relative size of the US economy: this will undermine the ability of the US to provide liquidity in times of crises, which could induce reserve holders to diversify away from the dollar
- In the near term there is no alternative to the dollar, but this may change if the euro area gets over its crisis and China internationalises the renminbi
- Reform of the international monetary system can help to smooth the changes

Long term consequences of continued global imbalances, cont'd

- Bank of Canada calculations: the potential difference between
  - a co-operative path for the global economy based on the G-20 framework (reduction in global current account imbalances), and
  - one in which markets forced fiscal adjustment on advanced countries and little else is changed
- They estimated a possible shortfall in global economic output of $7 trillion by 2015

Intra-EU current account balances (% EU GDP)

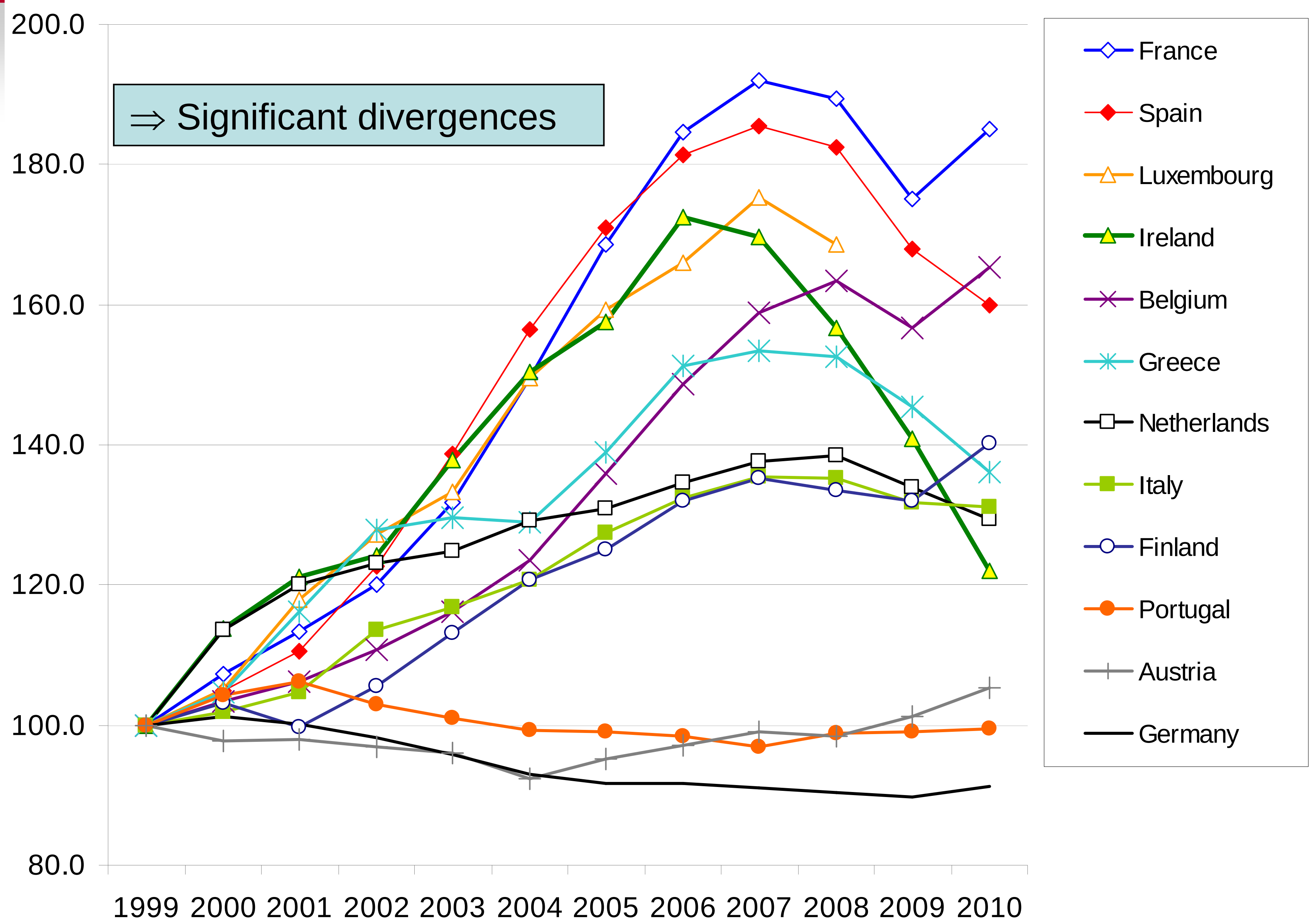


⇒ Significant widening of intra-EU current account imbalances since mind 1990s

⇒ Euro area as a whole is broadly in balance

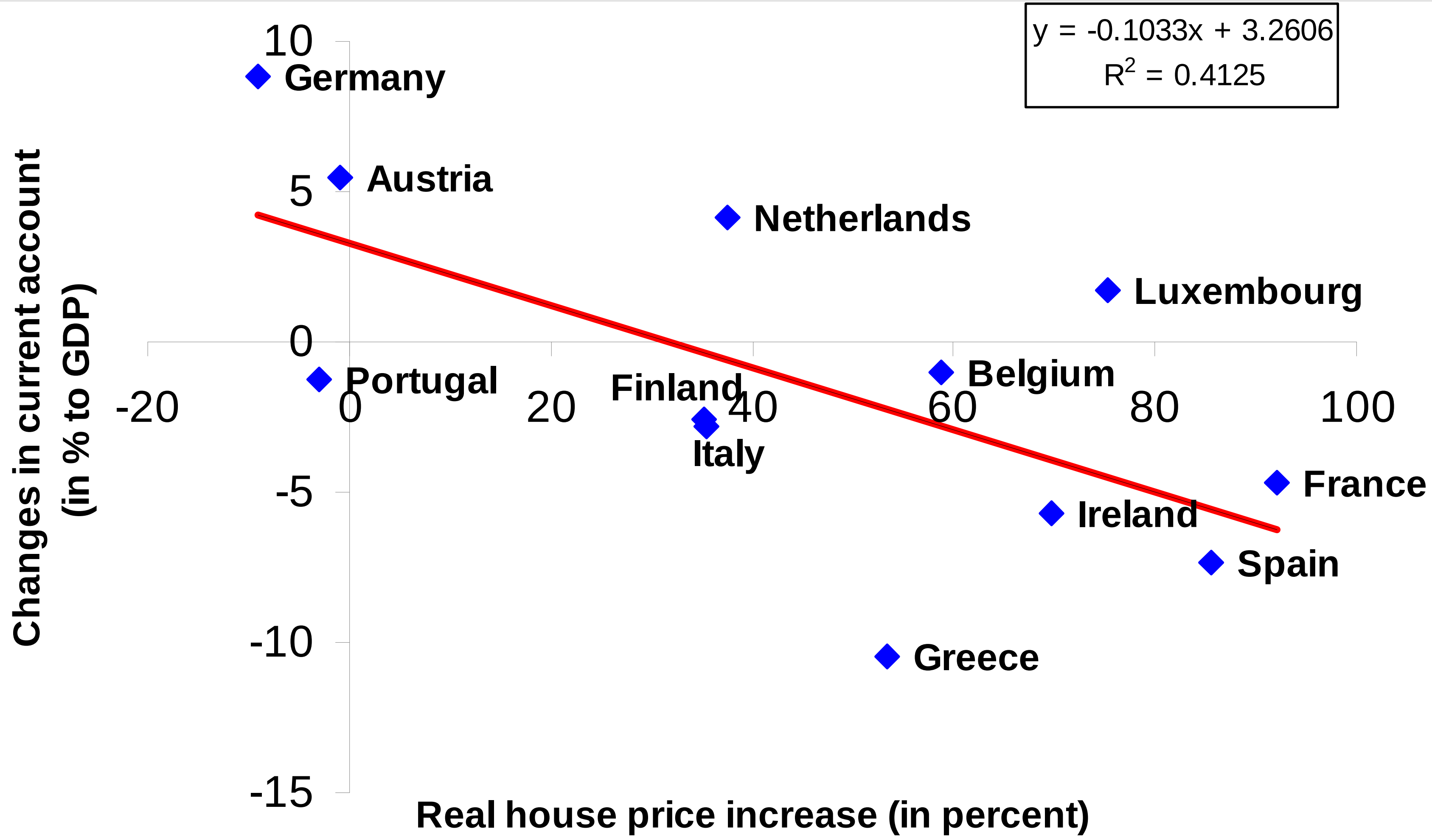
Source: Author's calculations based on IMF World Economic Outlook April 2011

Real house prices in euro area countries, (1999=100)



Source: Author’s calculations based on ECB and Eurostat data

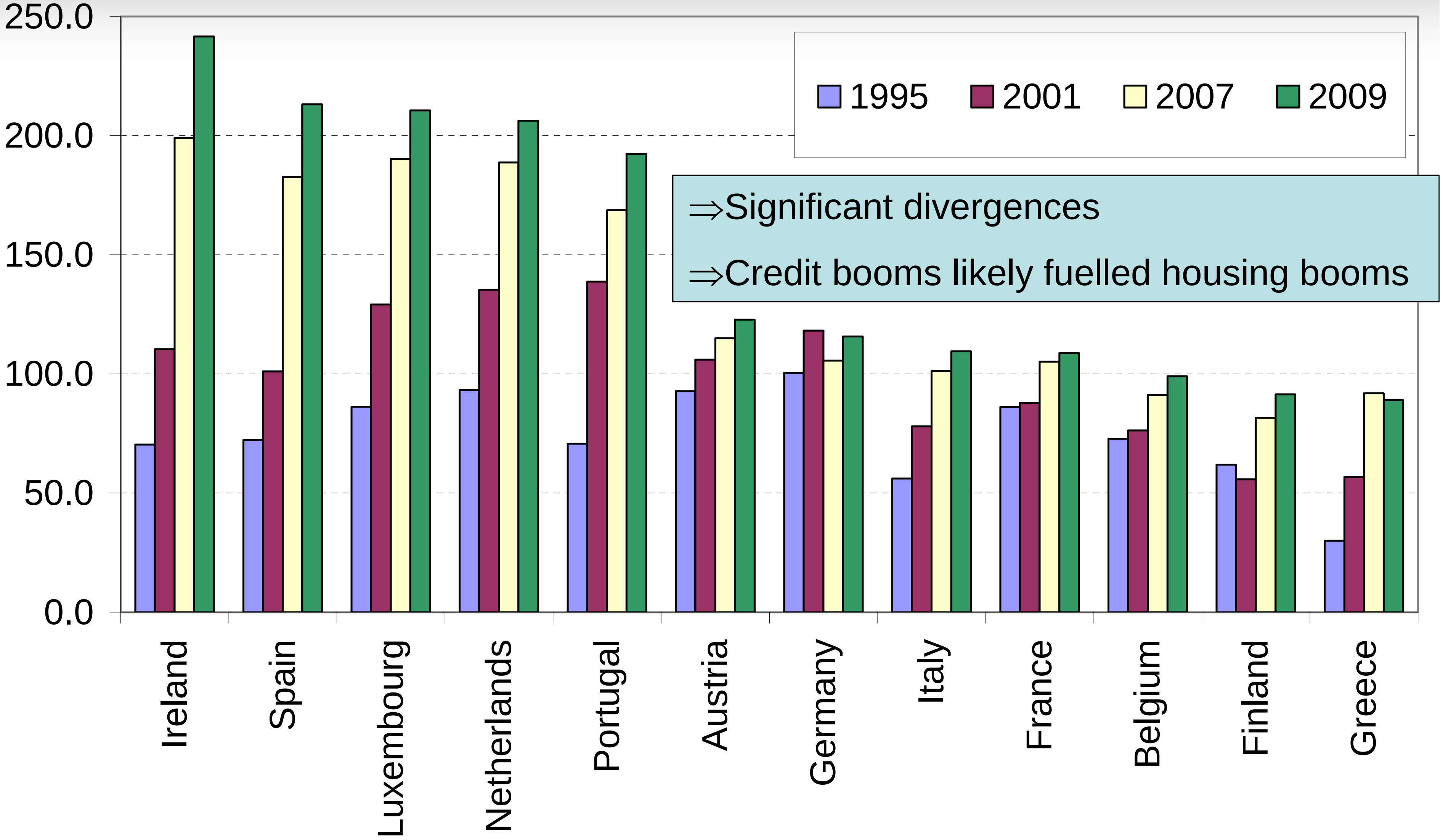
Changes in real house prices and changes in current accounts (1999-2007)



⇒ Pre-crisis current account developments correlate well with house price developments

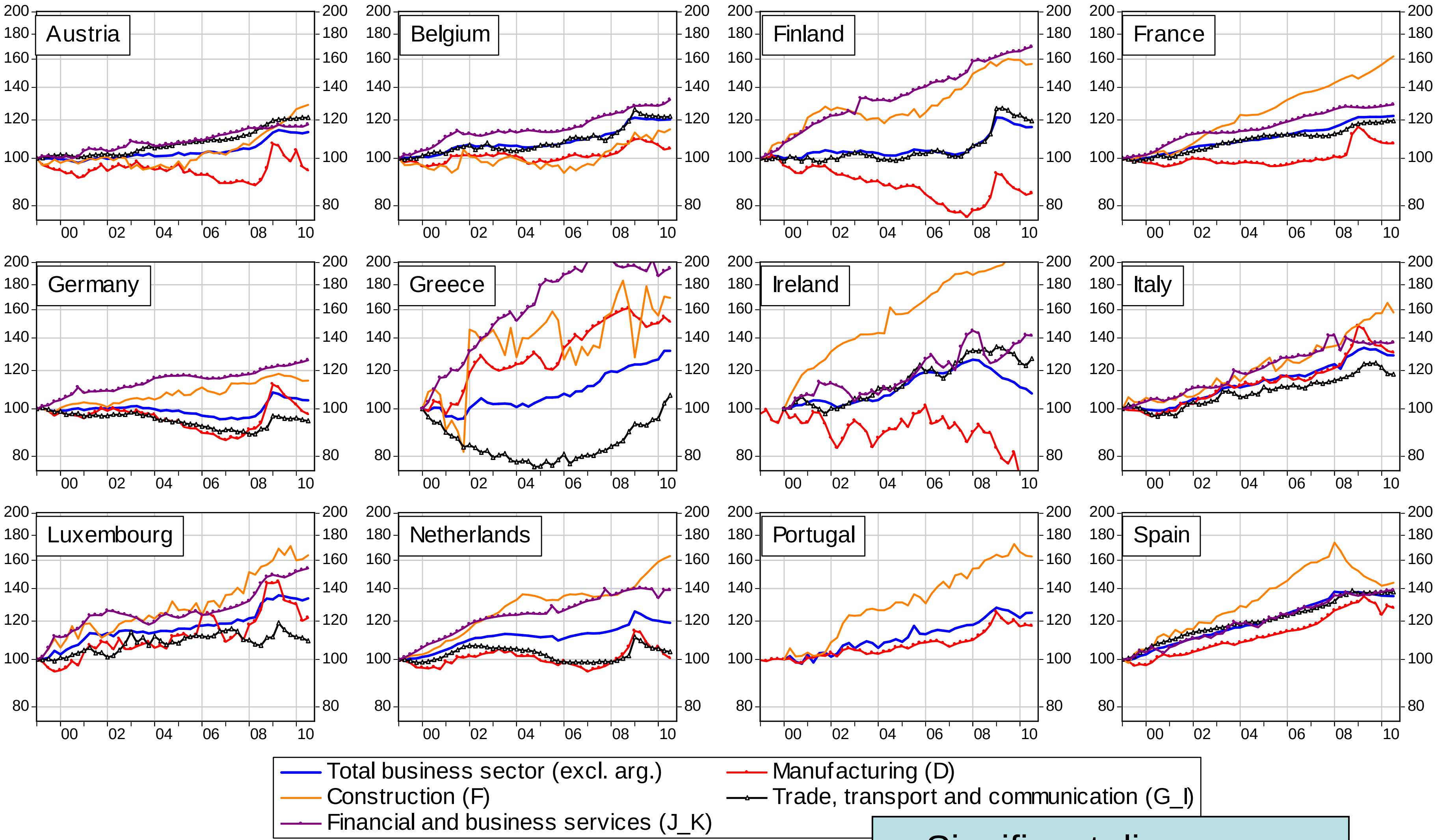
Source: Updated from Graph 34 on page 31 of DG ECFIN: Quarterly Report on the Euro Area, I/2009

Credit to the private sector (in per cent of GDP)



Source: Author's calculations based on data from IMF International Financial Statistics

Unit labour costs (ULC) developments (1999Q1=100)



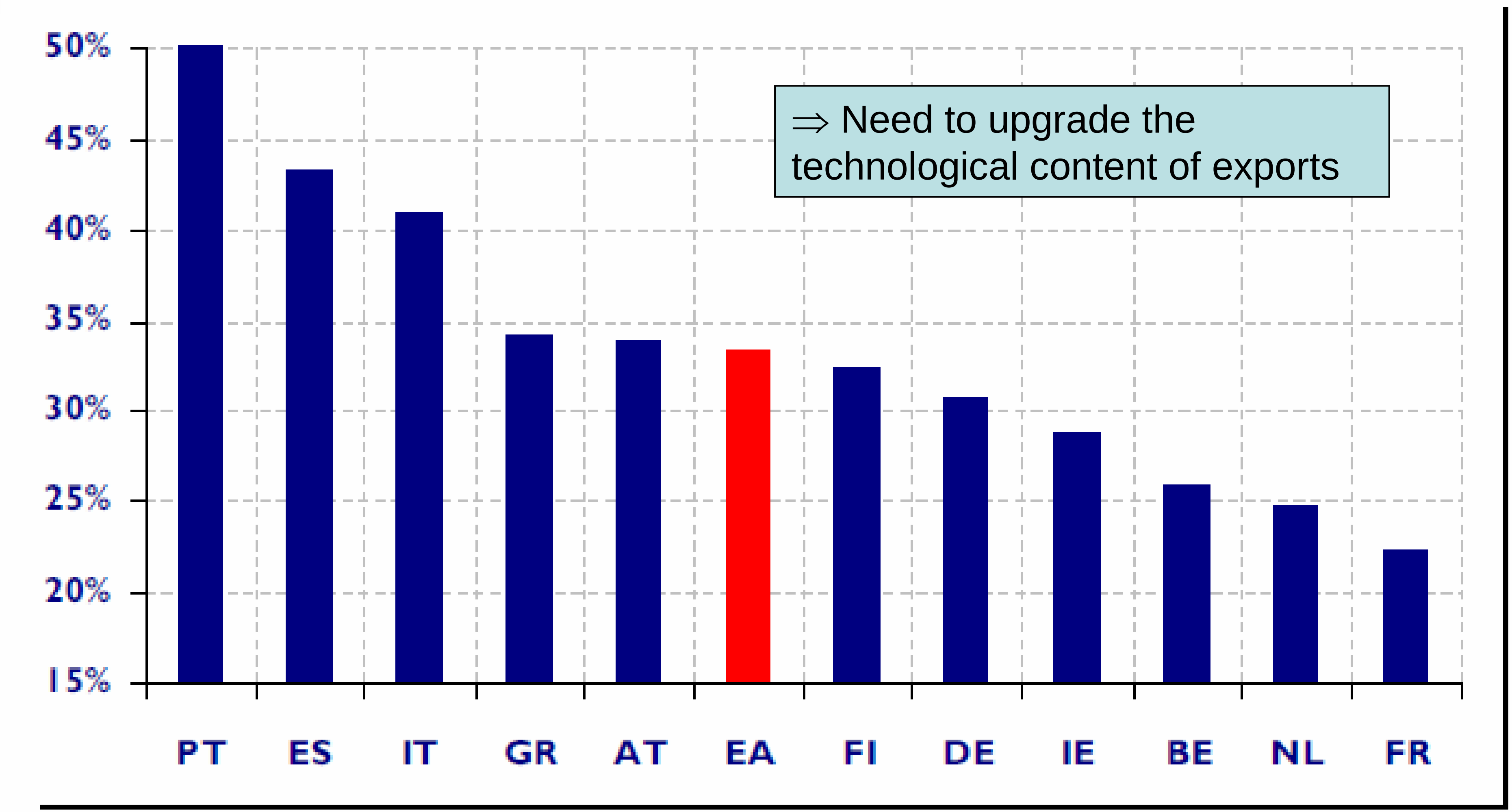
⇒Significant divergences

Source: OECD

Should Germany be blamed for the Spanish CA deficit?

- Finland, Ireland and Austria also gained competitiveness in the manufacturing sector; Belgium France and the Netherlands have not lost competitiveness
- Spain has lost competitiveness in manufacturing as well
- There was an excess demand in Spain: could a less competitive German industrial sector have prevented the rise Spanish CA deficit? (i.e. would the world supply less Germany is still close to unlimited regarding Spanish demand, though distance certainly matters)
- Europe share in global output is declining. Would a constrain on countries that gained competitiveness exaggerate this decline?
- The close to balanced external CA of the euro area is a taboo?
- Divergence of manufacturing ULC is also a characteristic of other monetary areas (Darvas, 2010)

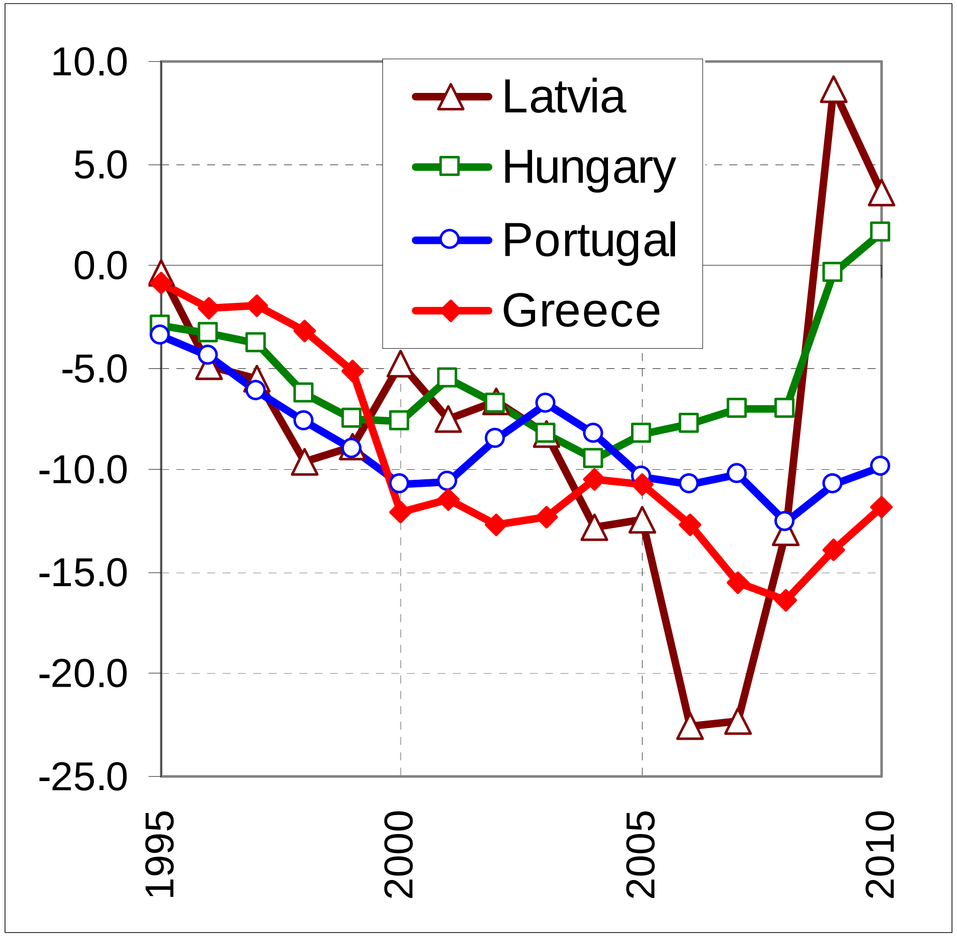
Degree of overlap in export specialisation between selected economies and China (average overlap over 2005-2008)



Source: Presentation slides by Lorenzo Bini Smaghi in Frankfurt am Main on 9 July 2010

(Non-)Adjustment of intra-euro area CA deficits

Current account (% GDP), 1995-2010



- Latvia and Hungary (non-euro area): sudden move to current account surpluses
- Greece and Portugal (euro area): small adjustment
- Hans-Werner Sinn: the cumulative CA deficit of Greece, Ireland, Portugal and Spain in 2008-2010 is almost identical to ECB lending to these countries

$\Rightarrow$ Instead of private capital flows, the ECB financed recent CA deficits

$\Rightarrow$ This cannot continue for long

Implications of intra-euro area CA divergences

- Caused by not just a better allocation of capital, but also unsustainable booms and loss in competitiveness in a couple of countries
- Deficits led to sharp increases in indebtedness $\rightarrow$ drags on demand and risks slow credit growth
- Deficit countries need to improve competitiveness, increase private savings, rebalance growth toward tradeables
- Surplus countries should not be less competitive, but they should reduce net domestic savings, ie boost domestic investment, and increase the growth potential of the non-tradeable sector as well
- Ongoing fiscal consolidation complicates these tasks
- ECB financed recent euro area CA deficits $\rightarrow$ cannot continue for long
- Important lessons for euro area (and EU) governance