Central banks and global imbalances

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It is a great pleasure for me to open this round table on "Central Banks and Global Imbalances" at the invitation of the Banco de España. I would like first to thank the organisers for giving me the opportunity to speak in front of such a distinguished audience.

The issue of global imbalances is indeed high on the agenda of every international economic policy and academic meeting. The facts are well known. In 2005 the current account deficit of the United States was estimated to have reached 6.4% of GDP, a level roughly matched by the combined current account surpluses of Japan, China, other Asian economies and the oil-producing nations. It is this diverging pattern that is generally referred to as the "global imbalances".

These facts are recognised, but that's as far as it goes. There is no consensus on the other elements surrounding the discussion on global imbalances. In particular, the factors behind the imbalances, their sustainability and the risk of disruptive adjustments are being closely examined by both academics and policy-makers, and frequently their conclusions diverge. Indeed, our panellists today hold contrasting views. Professor Axel Weber in a recent speech observed: "With regard to measures to reduce the current global imbalances the most urgent policy steps have to be taken by the US authorities". David Folkerts-Landau and his co-authors suggest, however, the possibility that no landing is necessary, that the current global imbalances reflect a conscious and stable arrangement between surplus and deficit countries, the so-called New Bretton Woods (NBW) system.

To start off the panel discussion, I will base my remarks on four questions that get to the heart of the issue. The four questions are: What are the factors behind global imbalances? Are global imbalances sustainable? Is there a need for policy adjustment? And, what role could central banks eventually play in the resolution of global imbalances?

1 What are the factors behind global imbalances?

Declining savings in the United States

A natural place to start to answer this question is obviously the US, where the increasing current account deficits seem to be due to a combination of factors. While rising investment was the driving force of this increase in the 1990s, falling savings have become the main contributor to the deficit since the early years of this decade. Indeed, the US national net saving rate is currently at around 1% of GDP, the lowest level since World War II. Both private and public savings seem to have contributed to this decrease.

As regards private saving, its decline has been mainly due to a drop in net household savings that in the course of 2005 – for the first time since the 1930s – fell into negative territory. Declining household saving could be the result of different factors, among which the economic literature has emphasised the role played by, first, the higher levels of productivity growth in the United States compared with its trading partners, implying larger returns on investment. Second, there is also some evidence that the lower US interest rates may have contributed to the decline in private savings, although in this case it is in practice difficult to identify the precise pattern of causality. Third, and related to this latter point, substantial positive wealth effects – triggered by the asset price bubble in the second half of the 1990s and soaring real estate prices since 2000 – may have helped to push down the low private savings rate in recent years. Finally, population ageing and distortionary tax incentives could have also played a role.

Turning to public savings, it is indeed a fact that the US general government fiscal balance swung from a surplus of more than 1% of GDP in 2000 to a deficit of around 4% of GDP in 2005. There is, however, an intense debate, ranging from academia to policy-making circles, on the extent to which a fiscal deficit translates into the current account. The consensus view is that there is a significant, albeit partial, statistical relationship between fiscal balances and current account positions, confirming partial Ricardian behaviour by the private sector. The aforementioned view implies that the US fiscal position matters as far as the current account deficit is concerned.

Saving glut: Asia and the role of oil exporters

Falling net saving in the US must have a counterpart somewhere in the world in the form of higher net saving rates. This high saving rate was referred to as a "saving glut" by Ben Bernanke (2005) and originates mostly from Asian countries and oil exporters. To better understand the determinants behind this behaviour, it is necessary to look at the different regions separately.

Starting with East Asian countries, excluding China, saving rates continue to be high in this region, but the switch into higher current account surpluses from the late 1990s onwards can be explained by a drop in investment around the time of the Asian crisis. In this case, it is therefore more accurate to speak of an "investment drought" rather than a "saving glut".

In China, by contrast, the high and increasing current account surplus cannot be explained by a fall in investment – investment is in fact remarkably robust, accounting for more than 45% of GDP – but by a very significant rise in national saving, which now amounts to more than 50% of GDP. The high level of household saving seems to be mainly due to adverse demographic developments (the ageing of the population), the lack of a social safety net and limited access to financial markets that do not allow savings to be channelled to productive investment.

An additional important factor influencing the current account surplus of Asian economies concerns exchange rate policies. The policy followed by some of these countries of fixing the exchange rate at very competitive levels has favoured the widening of trade surpluses in these countries and deficits elsewhere, but it has also forced Asian central banks to intervene to stabilise the undervalued exchange rates, leading to a massive accumulation of international reserves, with much of these reserves being invested in US dollar-denominated assets. Through these interventions, Asian countries have enabled the United States to finance a large and increasing current account deficit at relatively low interest rates.

Finally, let me refer to oil exporters. They constitute a group of countries where net saving is also high by historical standards. In their case, saving rates have increased following the higher oil income revenues since the late 1990s. Faced with this positive terms-of-trade shock, oil exporters have opted for a rise in saving and invested abroad; domestic investment has not reacted so far.

Related to this latter issue, I should add that in fact the rising oil bill has become an additional hurdle to the adjustment of the US current account deficit, partially explaining its worsening over the past few years: the oil bill (net imports) of the United States rose from 0.7% of GDP per year from the mid-1980s until the end of the 1990s, to 1.8% of GDP or around one-quarter of the US trade deficit in 2005.

Home bias

Let me finally refer to an additional factor that has been cited as contributing to the widening of the US current account deficit: the decline in home bias. By definition, rising current account deficits in a given country are possible if, and only if, foreign residents are willing to increase the value of the assets they have invested in that country. What prompts them to do so? One would think that return differentials are the main driving force but, as the recent experience of the

US shows, other factors play a role. In particular, the notion of home bias is a key element in explaining cross-border investments.

The concept of home bias refers to the fact that investors worldwide seem to be excessively investing in their home country. To quote Alan Greenspan (2005): "Home bias implies that lower risk compensation is required for geographically proximate investment opportunities". In an attempt to measure this phenomenon, one could say that having no home bias would imply that a country holds the same proportion of its financial assets abroad as the rest of the world market capitalisation is in the world.

Ongoing empirical research at the ECB indeed shows a significant decline in home bias for equity and bond financial flows in the mature economies since the late 1990s, which would help to explain why the US has found it particularly easy to fund its rising current account deficit. The fall in home bias was larger for euro area economies than for the US, and the level of home bias is lower in euro area countries (now around 65%) than in the US (above 70% for equities and above 90% for bonds). An important final point to be stressed is that the level of home bias is still very high in emerging countries, and therefore leaves scope for a future decline if one assumes convergence across countries.

Having finished this quick overview of some of the key factors behind global imbalances, I'll turn to the second question:

2 Are global imbalances sustainable?

This is of course not a trivial question. After all, we haven't yet seen any signs of an incoming disorderly adjustment of the imbalances and, as I mentioned earlier, there are some analysts who say that the current path can actually be sustained for a fairly protracted period of time.

This being said, there seems to be a broad consensus that the present constellation of current account positions cannot be maintained indefinitely. The US current account has led to a steady deterioration of the net US international investment position.

Back in 1980, the United States was a net creditor to the rest of the world to the tune of USD 360 billion, whereas at the end of 2004 it owed foreigners USD 2.5 trillion or around 22% of GDP. Between 2002 and 2004, this latter ratio remained stable in spite of large current account deficits, mainly because of large valuation gains, which were prompted by the depreciation of the US dollar, which in turn boosted the dollar value of foreign currency-denominated assets. However, it is unlikely that a permanent net debt devaluation strategy is sustainable, since it is reasonable to expect that international investors would end up asking for higher interest rates on US debt.

The previous dynamics point, in my view, to a need for a lower current account deficit in the United States. Let me illustrate this with the results from a simple arithmetic calculation. If the current account deficit of the United States continues to run at around 6% of GDP and nominal GDP grows at 5.5% a year – which is more or less the long-term consensus forecast for growth in the US – the ratio of US net foreign debt to GDP would increase to above 100% in the long run (if one excludes possible valuation effects).

In this context, the ability of the US economy to attract sufficiently large financial flows becomes crucial for the sustainability of the external deficit. Until 2000 the US current account deficit was financed by inflows into the domestic productive sector, taking the form of equity or direct investment. Recently, investors seem to have reassessed the longer-term profitability of US firms relative to earlier expectations and, as a result, net equity and foreign direct investment in the US have dried up and even gone into reverse, being replaced by large net inflows into the US bond market. In the last two years, virtually all of the net foreign inflows into the US have been debt-creating. The accumulation of foreign exchange reserves by Asian central banks and other reserve accumulators such as Russia, which mainly buy US government securities, have played an important role in shaping this trend.

From a flow perspective, the growing stock of debt interacts with the current account dynamics. In fact, the US is expected to face higher costs for servicing its rising debt. Over the past twenty years, the US income balance has consistently recorded surpluses ranging between 0.1% and 0.5% of GDP, although in 2005 this surplus shrank to a mere USD 1 billion (preliminary estimate), on the back of rising debt service obligations. Looking ahead, the income balance could turn negative as US interest rates continue to rise. A growing negative investment income would in turn imply a smaller sustainable trade deficit over the long run and complicate the current account adjustment.

Therefore, the relevant question is not whether, but when and how, the adjustment will take place, and this leads us to my third question:

3 Is there a need for policy adjustment?

At least two different arguments can be used to give a positive answer to this question. First, as indicated previously, several policies seem to underlie, at least partially, the existence of global imbalances. Second, even if policy is not the cause of imbalances, there is a great risk that a purely market-determined adjustment may be abrupt, with serious adverse effects on global economic growth and financial stability. Thus, policy may have an important role to play in preventing the market from overshooting, or should at least smooth the adjustment process and ensure that it does not disrupt the global economy.

In my own view, the most likely scenario will be one of a gradual and orderly adjustment of these imbalances over the medium term. Yet, I should add that such a "benign" scenario requires policy-corrective action to be taken, and I would like to quote President Kennedy's sound advice to policy-makers worldwide: "The best time to fix the roof is when the sun is shining".

The orderly unwinding of global imbalances requires global policy efforts, meaning that all major economies will have to make domestic adjustments. This is the bottom line of the G7 approach to the adjustment of global imbalances. In the *United States,* savings should increase – both through further fiscal consolidation and through an increase in private savings, which could be achieved through reforms of the US tax system, the elimination of distortionary tax incentives, and a shift towards higher energy efficiency. *Emerging Asian countries* are also expected to play a role in contributing to a smooth resolution of the global imbalances. Exchange rate flexibility is an essential element to ensure that necessary adjustments take place, together with reforms aiming at improving and deepening the financial sector. This would facilitate the resolution of both internal and external imbalances – insofar as high savings rates stem from low rates of return on financial assets. *Oil producers* could also contribute by fostering higher domestic investment – in particular, investment to enhance their oil extraction and refining capacities, to develop their infrastructures and to diversify their domestic production capacities away from oil. Finally, I will of course not forget the *euro area.* Our external position, with a roughly balanced current account, is very much in line with the structure of our economy and is consistent with demographic developments in the euro area, which require net savings over the longer term. Thus, the best contribution that the euro area can make towards resolving the global imbalances should come from further structural reforms aimed at increasing our growth potential. A similar line of argumentation to that of the euro area applies to Japan.

4 What role can central banks play in the resolution of global imbalances?

Let me now tackle the last part of my presentation, returning to the general issue raised by the organisers, on the link between global imbalances and central banks. I would like in particular to ask: what role can central banks play in the resolution of global imbalances? In other words, should monetary policy help foster the adjustment process and how?

It seems to me that an answer to this question encompasses three different issues: the role of monetary policy in achieving price stability, the way central banks should consider exchange rate changes and the question of whether and how central banks should react to an inflating asset market.

As I am sure that the other participants in this round-table discussion have their own views on the subject, I would just like to say a few words, taking mostly a euro area perspective, before I give them the floor. You will not be surprised if I start with price stability, our primary objective. In pursuing price stability, monetary policy makes its own contribution to economic growth in the euro area over the medium term. As such, this is an integral part of what the euro area can do to address the issue of current account imbalances. There is a large consensus today in Europe in respect of the continent's low growth over the last decade, namely that it is, to a great extent, structural in nature. The enhancement of potential output in the euro area should therefore be mainly based on structural reforms.

Regarding exchange rates, they are for us an indicator monitored under the economic pillar in our strategy. This means that the ECB does not react in any mechanical way to exchange rate changes; this is only one of the variables affecting economic developments and therefore influencing our decision-making. We will continue to take into account relevant developments, including the international environment, within a consistent framework aimed at ensuring price stability.

As mentioned earlier, when we consider other regions whose currencies are not fully market-determined, such as parts of emerging Asia, including China, there are, however, some indications that exchange rate policies have contributed to an unbalanced pattern of growth, with an excessive reliance upon external demand, leading to rising current account surpluses and investment activity in the tradable sector. Moving to a more flexible exchange rate regime is also in this case an effective way of avoiding an accumulation of excessive levels of reserves, and it is only one of the advantages of such a strategy. Indeed, a second consequence of the choice of a fixed exchange rate in China and other emerging economies in Asia concerns the domestic repercussions. With the external constraint of a fixed exchange rate, it is more difficult for a central bank to achieve domestic objectives, such as effectively controlling credit growth. There are some signs that tend to support this argument, notably the fact that money growth is growing above its target in China and that money growth volatility has increased with rising foreign exchange interventions.

At the current juncture, and for the long-term development of China, it seems therefore essential to gradually gain more flexibility regarding the exchange rate arrangement and to focus monetary policy on domestic objectives. This would imply a gradual and orderly adjustment of the currencies of countries with large external surpluses, in consistency with a rebalancing of the growth pattern of emerging countries in Asia. By strengthening in particular the domestic financial sector, this additional flexibility would further contribute to a smooth resolution of global imbalances. In this respect, I am only reiterating the recommendations outlined in the last G7 communiqué.

Finally, it has been argued that asset price bubbles have contributed to the growing current account deficits since the late 1990s (see, for instance, Kraay and Ventura, 2005). In this respect, a distinction could be made between asset price developments in the context of the "new economy" bubble and potential misalignments of asset prices observed in the recent period as global liquidity conditions remained generous for an extended period of time. While the mechanism behind a possible relation between asset prices and external positions may be analysed in the context of lower home bias and increased capital flows, the question of whether and how monetary policy-makers should and could react to such developments is much harder to answer. All the same, let me submit this question as a possible subject for debate in our panel discussion.

To sum up, I have presented what are, in my view, some of the main factors behind global imbalances, as well as the policy measures that can be implemented to ensure an orderly correction of these imbalances. I have also raised a few issues for discussion, focusing on the role that central banks can play in the resolution of global imbalances.

I now would like to give the floor to the other panel participants. We are honoured to have here today Vittorio Corbo, President of the Banco Central de Chile; David Folkerts-Landau, Managing Director and Head of Global Markets Research at Deutsche Bank; Vincent Reinhart from the Federal Reserve Board as well as Axel Weber, President of the Deutsche Bundesbank.

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