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Global imbalances: causes and challenges

Introductory remarks

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1 Introduction

Ladies and gentlemen,

I am highly delighted to welcome you to this notable conference at the Bundesbank Training Centre in Eltville. Central bankers and other officials from 42 countries have gathered here today to discuss various experiences and common challenges. I would like to thank Mr Thomas Gierenstein and Mr Jürgen Sterlepper as well as their team for organising this conference.

We are holding it to celebrate 20 years of technical central bank cooperation within the Bundesbank. While the Bundesbank has always been available to provide foreign central banks with technical assistance, the momentous events of the early 1990s prompted the Bank to institutionalise this kind of work.

It was, in particular, Hans Tietmeyer, my pre-predecesssor and Vice-President at the time who was quick to grasp the far-reaching importance of those historic events for central banking: the fall of the Iron Curtain, the collapse of the communist regimes in central and eastern Europe, the subsequent transformation in those countries from a planned economy

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to a market economy as well as the break-up of the Soviet Union and the resulting formation of new, independent states. Many of those states had to start from scratch in establishing their own national central banks. All things considered, there was a major and vital need for central bank cooperation.

Hence, in the first few years of its existence, the activities of the Bundesbank's "Technical Central Bank Cooperation" were very much focused on the process of restructuring the banking system in those countries. This meant transforming formerly state-owned banks into a two-tier banking system consisting of an independent central bank and profit-oriented commercial banks.

Later on, activities were concentrated on helping central and east European countries to navigate their way to the European Union. Seminars at the time were aimed, in particular, at the smooth integration of the accession countries' central banks into the European System of Central Banks. After this phase was successfully concluded with those countries' accession to the EU, Central Bank Cooperation widened its scope in terms of its geographical reach and activities. In the era of globalisation, cooperation among central banks has generally become much closer. This is, of course, especially true of cooperation among major central banks. But, given the importance of price stability, a well-functioning banking system and, let us remember, central bank's macroeconomic expertise as a useful asset for other central government bodies, we also consider it important to engage in a constant exchange of expertise and knowledge with central banks of developing and emerging countries.

Most recently, the financial crisis has significantly affected the activities of Technical Central Bank Cooperation – all the more so as the Bundesbank is a valued partner in dialogue in

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this regard. In terms of its geographical scope, the activities of our Central Bank Cooperation currently cover EU accession and candidate countries, successor states of the former Soviet Union, central Asia and China. Furthermore, the Bundesbank is committed to continuing its support for the Federal President's programme "Partnership with Africa". In sum, it is in contact with almost 90 central banks – many of which are represented today at this conference. Of course, the Bundesbank is not the only supplier in this field. We are therefore especially pleased to welcome members of the counterparts of our own Technical Central Bank Cooperation from the ECB and other central banks of the ESCB who are also attending this conference.

Admittedly, exporting our "central bank philosophy" is a major motive behind our efforts in this domain. Many of you will agree with me that central banks have become both the most modern and most reliable public institutions in many developing, emerging and transformation countries. The Bundesbank will therefore continue to actively cooperate with its partner central banks. The first 20 years of the Bundesbank's Technical Central Bank Cooperation are a story of success and I am confident that the story will go on.

2 Global imbalances

Globalisation and, therefore, greater macroeconomic interconnectedness have increased the wealth of nations. Nevertheless, over the past decade, globalisation has also been accompanied by growing current account and financial imbalances. While the financial crisis has been associated with a narrowing of imbalances, recent data suggest that this development has started to go into reverse, at least partially. In view of their global

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importance, I would like to focus my remarks today on these global imbalances, and I am looking forward to discussing these issues with this global forum afterwards.

Current account imbalances are not a bad thing *per se*. On the contrary, from the viewpoint of a single national economy there may be good reasons for temporary surpluses or deficits. A surplus or deficit merely reflects a discrepancy between domestic savings and investment. For countries with an ageing population like Germany, it is a matter of rationality to save more than to invest domestically since the number of investment projects with good prospects is declining, whereas households want to maintain their level of consumption in old age. Similarly, countries that export an exhaustible resource would be well advised to invest some of the proceeds abroad so that future generations can benefit from the resources as well. Current account surpluses will therefore fade out over the medium to long term and probably eventually turn into deficits, as the accumulated net foreign assets are gradually reduced.

On the other hand, countries that are catching up on economic development usually invest more than they save. Given a wide variety of investment opportunities but scarce capital, they rely on foreign inflows of funds. In such cases, temporary current account imbalances are fundamentally unobjectionable.

By allowing economies to separate domestic absorption from output – which is, by definition, not possible in closed economies – current account imbalances are welfare-enhancing since consumption is smoothed over time and because capital flows from economies with net savings to countries where the marginal return on investment is higher. This, however, requires a productive use of the capital inflows in the deficit countries. Overall welfare will be adversely affected, for example, if capital inflows mainly fuel a speculative housing bubble. It

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has now become obvious that unproductive use of foreign capital was widespread in the years prior to the financial crisis and that several countries have been living beyond their means.

Regarding the debate on whether global imbalances were among the causes of the financial crisis, I do not, however, consider them to have triggered the crisis. Rather, I think that deficiencies in the financial system were at the core of the crisis, whereas global imbalances intensified and accelerated the resulting chain of events.

Indeed, many of the persistent high current account positions that have emerged over the past decade are neither benign nor sustainable. The large U.S. deficit is due, first and foremost, to low national savings. On the other hand, the current account surpluses of major emerging economies are, to a significant degree, the outcome of exchange rate policies that helped merchandise exports to grow. Rather than investing the financial surpluses domestically, China, in particular, continues to accumulate substantial foreign exchange reserves – mainly denominated in US dollars. While this strategy appears to be rational from the surplus country's point of view, it is partly responsible for making the global economy more vulnerable to adverse shocks.

The recent financial and economic crisis has caused a sharp decline in current account positions. The U.S. current account deficit – which in absolute terms is still largest of the world – decreased significantly from 6.0% of GDP in 2006 to 2.7% in 2009. The Chinese surplus, which peaked in 2007 at 10.6%, will go down to 4.7% this year according to the most recent IMF projections. However, in contrast to the U.S. current account deficit, which the IMF expects to increase only slightly over the next years, the Chinese surplus – in absolute terms the largest – is projected to re-increase significantly, to nearly 8% of GDP in

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2015. The current account surpluses of oil-exporting countries, which more than halved owing to lower oil prices, are also expected to re-increase, although nowhere near to the pre-crisis levels. In the case of China and the oil-exporting countries, the recent narrowing of current account positions was due mostly to cyclical adjustment. In the United States, however, cyclical factors have played a less important role with regard to the recent decline than permanent factors such as a structural upward shift in the private savings ratio.

The current account of the euro area has been quite balanced over the past decade and continues to be so. The position deteriorated slightly and turned negative in 2008. Nevertheless, it is fluctuating around 0% and is not forecast to increase significantly over the coming years. Therefore, the euro area and its economies have not contributed to global imbalances. This overall figure, however, masks economic divergences within the euro area.

Large and persistent current account deficits in a number of countries on the geographical periphery of the euro area are the result of a combination of strong growth in demand, higher than average inflation and deteriorations in price competitiveness during the first decade of monetary union. Hence, the underlying distortions that led to these external imbalances were mainly domestic in nature – unsustainable developments, as was recently revealed by the financial and economic crisis. While their impact on global imbalances is rather limited, major macroeconomic imbalances within the euro area have proven to be a hazard for the single currency area as a whole.

When it comes to correcting intra-euro area macroeconomic imbalances, the bulk of structural adjustments has to be undertaken by the deficit countries themselves as it was there that domestic developments became unsustainable in the years prior to the crisis. Although the crisis has led to a correction that is not just cyclical, including a cooling-off of

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housing markets, it is of great importance for the euro-area economy that the adjustment process in the deficit countries continues. Against this background, compensatory measures taken by euro-area countries with current account surpluses, like wage increases or a more expansionary fiscal policy stance, would be neither necessary nor helpful. Furthermore, it has to be stressed that Germany's current account surplus, for example, is the result of decentralised market processes. This is an important difference between EMU surplus countries and some emerging economies where a market-driven correction of imbalances is significantly hampered by policy interventions.

To sum up, as the underlying causes of global imbalances are mainly still operative, imbalances are continuing to pose risks to the global economy and are incompatible with the G20's goal of strong, balanced and sustainable growth. The financial and economic crisis has not removed global rebalancing from the global policy agenda. Pre-crisis policy advice is still largely relevant. While global rebalancing may have become even more challenging – even more so as major economies have not yet fully digested the recent crisis – it is encouraging that global leaders have acknowledged the importance of the issue.

The G20 "Framework for strong, sustainable and balanced growth" is a sometimes tedious, but important advance in this regard. In contrast to the multilateral consultations that were held in 2006 and 2007, the G20 commitments are backed by the leaders and include all major stakeholders. Furthermore, the Mutual Assessment Process could provide the opportunity for exerting peer pressure among members, which is considered to be more effective than institutional surveillance.

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Still, we should not rely too much on the effectiveness of the framework itself. At the end of the day, it is up to the national authorities to implement the necessary measures in order to reduce imbalances.

Emerging surplus countries as well as oil-exporting countries should pursue measures to increase domestic demand. In some cases, in particular China, it is a well-known fact that more flexible exchange rate regimes would help redirect growth from export to stronger domestic demand. At the Toronto Summit, emerging surplus economies agreed to undertake reforms to enhance exchange rate flexibility. Market-oriented exchange rates that reflect underlying economic fundamentals contribute to global economic stability. Therefore, the recent appreciation of the Chinese renminbi is a welcome further step towards appropriate valuation.

Higher exchange rate flexibility should, however, be supplemented by structural reforms, especially as their positive impact is more sustainable. In the case of China, this includes, for example, measures to reduce precautionary household saving by improving social security or measures to strengthen corporate finance.

The advanced G-20 states have pledged to halve their public deficits by 2013 and to stabilise their debt ratios by 2016. The deficit countries among them have committed themselves, beyond budget consolidation, to supporting private savings, to strengthening their export sectors and to maintaining open markets. In the United States, private savings have already increased, whereas the public deficit is still high. Budget consolidation will be challenging but will be good for the U.S. and help rebalance the global economy.

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The surplus countries, in turn, have committed themselves to strengthening domestic sources of growth, in particular by implementing structural reforms depending on national circumstances. Germany is a case in point. Comprehensive and sometimes painful labour market reforms have helped to make the labour market significantly more flexible. The dividend from these structural reforms was a robust labour market during the downturn, implying comparatively robust private consumption. Meanwhile, the unemployment rate has gone back down below its pre-crisis level and economic growth is increasingly based on domestic demand. Boosting demand by means of further macroeconomic stimulus measures would, however, be inappropriate and, at least in the case of Germany, highly procyclical.

3 Conclusion

Let me conclude.

Global imbalances still pose significant risks to the global economy. The unwinding of global imbalances is therefore one of the major challenges on the global policy agenda. It is a joint task of surplus and deficit, of advanced and emerging economies.

Thank you for your attention.

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