Hermann Remsperger: Global imbalances and policy implications

Speech by Dr Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, at the Wilton Park Conference "How best to promote growth, employment and competitiveness in the European Union?", Eltville, 9 May 2006.

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I must say that I find the traditional Wilton Park motto “Bridging divides” truly fascinating. And the more I think about it, the clearer it becomes that this motto could also describe the work of central bankers.

Just consider, for example, the dividing line between the media and market players on the one side and central bankers on the other. Bridging divides is a core function of communication in monetary policy.

The question often arises: Why is this communication so difficult? Many people think that the asymmetric distribution of information is to blame. I do not share this opinion. In my view that information is distributed quite symmetrically between markets and central banks.

I see a kind of time inconsistency as being the deeper-rooted reason for major challenges in monetary policy communication. The forward-looking approach of market players and the media is inevitably focused on meetings, the precise outcome of which is usually not yet known even by the monetary policy decision-makers themselves. In my opinion, it would certainly help to bridge the divide between the media, market players and central bankers if everyone bore this simple fact in mind.

Nevertheless, communication would, even then, still involve some stress. As Laurence Meyer, the former Fed Governor, put it: “Preparing a speech is a joy.

Giving a speech is fun. Dealing with the aftermath of the speech is the only thing where there is stress.”

I have to admit, however, that preparing and giving a speech is not always joy or fun. Let me be very frank: I feel stressed right now. As my participation at the Wilton Park Conference was only decided a few days ago, I simply did not have the time to prepare a talk on the original topic. And that is why I would ask you to forgive the fact that I will not be speaking on the subject that had been planned for my colleague Professor Stark.

Instead I would like to make some remarks on global imbalances. However, as you will see in a few minutes, the policy conclusions that we have to draw for Europe in general and the euro area in particular with a view on reducing global imbalances are very much in line with the agenda of this conference.

Growing current account imbalances have been shaping developments in the world economy for some years now. In 1999, the US current account deficit exceeded 3% of GDP – a ratio which, for a long time, had been regarded as critical for the long-term sustainability of a negative net savings position.

Since then, the growing asymmetries in the global current account structure have often been portrayed as a risk to the world economy. Above all, warnings are made about the potential consequences that a sharp correction of current account balances might have for the world economy. There is a worry that tensions in the financial and foreign exchange markets, accompanied by frictions in the real economy, may occur.

Now, there happen to be a number of approaches in the literature which seek to explain why the risks of the global imbalances have not manifested themselves so far or why they are not such a problem as is often assumed. I will address these in a minute. To make the outcome clear from the start: even after analysing these approaches, which can be labelled for short as “global savings flows”, “Bretton Woods II” and “dark matter”, I see no reason to neglect the global imbalances in the economic policy debate. But the prospects of a more equal distribution of global economic growth do give hope that the necessary adjustments will gradually come under way.

I Trends in globalisation

So that my comments on global imbalances may be better understood, I would like to begin with emphasizing three trends in globalisation. First, for some decades now, world trade has been growing

faster than global economic output. On an average of the past 30 years, world trade has increased one and a half times more than global GDP. In the 1990s, world trade grew more than twice as much as global output. Accordingly, the openness of many economies – in other words, the ratio of exports plus imports to GDP – showed a substantial increase. In Germany, the ratio last year reached more than 75%. That is very high for a major industrial country. The comparable figure for the United States and Japan is just over 26%.

The second trend I would like to mention is the internationalisation of production. This is reflected, for example, in the rise in cross-border direct investment. For many companies, it has become more important and, at the same time, easier to take a global perspective. Accordingly, national borders are becoming less important in production and sales decisions.

Initial estimates by UNCTAD show that cross-border flows of direct investment in 2005 totalled almost US$900 billion. This was around 30% more than in 2004. There are now about 70,000 enterprises worldwide that are organised transnationally. They have about 690,000 foreign subsidiaries. These global players account for around two-thirds of world trade, half of which is in the form of intra-group trade.

German enterprises, too, have increased their international activities. German firms account for 8½% of the global stock of foreign direct investment (FDI). For 2004, the Bundesbank's FDI statistics show around 22,700 affiliates abroad with 4½ million employees.

By the same token, foreign firms are, of course, investing in Germany. I do not want to go into this subject in detail at this point, but I would like to take the opportunity to counter an impression which recently gained a lot of attention. It was reported that the levels of FDI stocks in France are twice as high as in Germany. Evidently, however, market values were being compared with book values. Using book values for both countries shows higher FDI in Germany than in France.

Besides the growing links in production and international trade, the increasing global integration of the financial markets is, as I see it, the third major trend in globalisation. More and more countries have access to the international capital market. There has been a significant increase in the volume of cross-border securities transactions. In the case of Germany, for example, turnover in cross-border securities transactions amounted to almost 600% of GDP in 2005 – which is 80 times more than 25 years ago.

The sharp increase in global foreign exchange market transactions is a further major indicator of globalisation in the financial sector. According to figures provided by the Bank for International Settlements, for example, daily foreign exchange market transactions in 2004 amounted to US$1,880 billion. This is more than a threefold increase on the late 1980s, and corresponds to 42 times the value of world trade.

This astonishing increase in foreign exchange market trading which is not directly linked to transactions in the real economy has a number of different reasons. Explaining factors are likely to be increasing investor orientation towards cross-border investments as well as a more active investment management and the growing importance of hedge funds.[1]

Overall, countries' financial openness has increased significanty. This openness can be expressed as the ratio of the sum of external assets and liabilities to GDP. For Germany, the degree of financial openness in 2004 amounted to around 300% – three times higher than in 1990.

For the United States and the United Kingdom, this indicator roughly doubled in the same period. Owing to the particular role of London as an important international financial centre, the United Kingdom showed a degree of financial openness of more than 700% in 2004.

Globally integrated financial markets are expanding the investment spectrum, reducing capital costs and contributing to greater market liquidity, price efficiency and risk distribution. Along with the advancing integration of the financial markets, investors' "home bias" will probably continue to diminish, too. This, in turn, will reinforce the convergence process and facilitate the cross-border allocation of savings.

[1] See BIS (2005), Triennial Central Bank Survey, Foreign Exchange and Derivatives Market Activity in 2004.

II Global savings flows

Right here there should be a moment's pause for thought as we have come to a crucial point. We have to look at global imbalances from two angles – first, from the perspective of the current account balance and, second, in terms of the balance between saving and investment. Ultimately, these are two sides of the same coin: Countries with a current account deficit absorb savings from abroad and countries with a savings surplus transfer resources abroad.

The scale we are dealing with here is revealed by looking at the global current account structure. The US current account deficit last year of US$805 billion – 6.4% of GDP – stood in contrast to current account surpluses of US$164 billion in Japan, US$159 billion in China and a further US$86 billion in some Asian emerging economies, and US$259 billion in the OPEC countries.

The euro area was running a current account deficit equivalent to US$28 billion.

However, looking briefly only at the German current account, it is plain to see that Germany, too, with a surplus of US$115 billion (€92 billion, 4.1% in relation to GDP), provides net savings to other countries on a large scale.

In macroeconomic terms, this reveals that – unlike in the 1990s – domestic saving in Germany has no longer been fully absorbed by domestic aggregate fixed capital formation. At 2¾% to 3% of disposable income in the period from 2002 to 2005, the overall net investment ratio was very low compared to the first half of the 1990s, when it was between 9% and 12 %. And in the second half of the 1990s it was at roughly 8%.

In other countries, too – above all, in parts of Asia – the rather subdued investment, along with a high level of savings, has led to the creation of a saving surplus that was available for investment in the international capital markets. Over the past few years, rising net savings of the oil-producing countries have been an additional factor, which means that the global transfer of financial resources is also being shaped by high oil prices.

In short, capital has been flowing from emerging economies to industrial countries, particularly to the United States. As mentioned, the US national saving gap was more than 6% of GDP in 2005. Along with a negative private financing balance, the government budget deficit has also been a major contributor (in 2005, the budget deficit was around 4% of GDP).

The large US current account deficit, which contrasts with positive net savings in other parts of the world, has been taken up as part of the "global savings glut"[2] theory. One of its key propositions is that the US current account deficit has not only been financed but also shaped by the net savings in many other countries.

From this perspective, the US deficit is essentially the product of economic developments in other countries and, therefore, endogenised: The increased supply of net savings in various parts of the world during the past decade is said to have made the United States a net importer of capital and, at the same time, ensured relatively low real interest rates.

It is claimed that several factors have determined the increase in net savings outside the USA. In industrial countries with an ageing population, so the argument goes, there is a major incentive and need to save more.

In many emerging and developing countries, experience of the financial crises, in particular, has led to a build-up of currency reserves for precautionary reasons which has made them suppliers – rather than demanders – of capital.

At this point – if not earlier – one has to wonder, however, whether saving and investment behaviour outside the United States, which has allowed the US current account deficit to be financed relatively easily so far, is "immutable". I doubt it, not least because some of the saving surplus is due to special factors outside the United States that can hardly last for ever.[3]

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[2] Bernanke, B.S. (2005), The Global Saving Glut and the U.S. Current Account Deficit, Speech at the Homer Jones Lecture, St. Louis, Missouri.

[3] See IMF (2005), World Economic Outlook, Building Institutions, Washington DC.

Ben Bernanke, too, has said in commenting on the "global savings glut" that the "current pattern of international capital flows – should it persist – could prove counterproductive" in the longer term.[4] Above all, it is difficult to predict whether and at what price markets are prepared to contribute more or less indefinitely to the transfer of resources between the various regions of the world.

As I have just indicated, however, this is not just a matter of how private economic agents behave. Central banks are also players in this game. That is revealed by looking at the global stock of currency reserves, which roughly doubled between late 2001 and late 2005, although a certain deceleration in the build-up of foreign exchange reserves was apparent last year.

What determined the sharp increase in currency reserves, especially between 2002 and 2004, was the exchange rate policy of some Asian countries seeking to support their currencies' peg to the US dollar. This meant that, for a number of countries, the central banks' currency purchases were, at times, the main vehicle for investment abroad.[5]

Of the ten largest holders of currency reserves, eight are countries in Asia. China and Japan alone account for a total of roughly 40% of the global stock of those reserves.

III Bretton Woods II

Against the backdrop of these developments, it is only a small step to the idea of a revived Bretton Woods. The short way of putting this – "Bretton Woods II" – is intended to express the idea that exchange rates are shaped by a voluntary, semi-institutional exchange rate system.[6]

The growing US net saving gap, it is claimed, is being financed without major difficulty because some Asian central banks are prepared to accumulate large stocks of dollar reserves. As these countries have an interest in supporting their national economic policies by fixing the exchange rate, US current account deficits can be financed by the accumulation of currency reserves elsewhere and therefore persist.

Essentially, the proposition of Bretton Woods II does highlight one major aspect of global imbalances. The comparison between a voluntary, unilateral peg of the exchange rate of various Asian currencies to the dollar and multilateral agreements such as the 1944 Bretton Woods agreement, however, is not quite accurate. Furthermore, the main point is that market interventions also involve costs for these countries.

For central banks, growing dollar reserves also mean a growing risk of losses should the US dollar depreciate.[7] Their incentive to give more consideration to other currencies in the portfolio might become stronger. However, it also seems doubtful whether the avoidance of foreign exchange losses motivates central banks' actions.

Another aspect of "Bretton Woods II" is the growing importance of dollar reserves in the intervening central banks' balance sheets for their countries' monetary policy. Many of the Asian central banks have sterilised the bulk of their reserve purchases.[8] Besides costs resulting from possible changes in the exchange rate, these sterilisation costs also have to be borne in mind.

In actual fact, in the past few years there has been a certain easing of the alignment of some Asian currencies' exchange rates with the dollar. In March 2004, Japan discontinued its currency market interventions. Since then, the Japanese foreign exchange reserves have been nearly unchanged. The authorities in Korea, Taiwan and Singapore also were already allowing fairly large fluctuations of their currencies in the course of 2004.

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4 Bernanke, B S (2005), loc cit.

5 See Higgins, M/Klitgaard, T (2004), Reserve Accumulation: Implications for Global Capital Flows and Finanicial Marktes, Federal Reserve Bank of New York, Current Issues, Vol 10, No 10, September /October 2004.

6 See Dooley, M P/Folkerts-Landau, D/Garber, P (2003), An Essay on the Revived Bretton Woods System, NBER Working Paper 9971.

7 See Roubini, N/Setser, B (2004), The US as a Net Debtor: The Sustainability of the US External Imbalances, Stern School of Business, NYU und University College, Oxford.

8 See Higgins, M/Klitgaard, T (2004), loc cit.

The build-up of currency reserves in those countries has now lost momentum. Last year in July, the transition to a new exchange rate regime was initiated in China. Overall, this means that some modification of the exchange rate arrangements has now been put in place.

This transformation is also reflected in the US financial account. In 2005, unlike earlier years, currency purchases by public investors no longer made the largest contribution to financing. The idea of a "Bretton Woods II" system has therefore already become somewhat less relevant – especially as the oil-exporting countries have become more important for financing the US current account deficit.[9]

IV Dark matter

While the idea of Bretton Woods II has been attracting less public attention of late, there is now a more lively debate on a line of reasoning that the US negative net foreign asset position is mitigated by the fact that net cross-border investment income is still positive. In 2004, for example, the United States had a negative international investment position of US$2.5 trillion. In the same year, however, US$36 billion flowed into the USA as investment income.

Now, in order to explain this apparently contradictory situation, Ricardo Hausmann and Federico Sturzenegger have recently referred to "dark matter", arguing that the US negative net foreign assets are due to statistical shortcomings. They say that an analysis of the investment income clearly shows that the US assets abroad – measured by their earning capacity value - exceed the liabilities to non-residents. The USA, they argue, is generating income from unseen assets, which they call "dark matter".[10]

"Dark matter" is a term from the astronomy describing the discrepancy between real matter – which can be deduced from the gravitational force operating in the galaxies – and visible matter.

The phenomenon of positive net investment income alongside negative US net foreign assets had already been discussed earlier in the literature.[11]

As I see it, dark matter does not necessarily have to be used as an argument in order to explain positive investment income alongside negative net assets. For example, the IMF had already pointed out earlier that US investments abroad generate a higher average return than foreign investment in the United States.[12]

This advantage is due, in roughly equal parts, to the composition of the assets and the differing profitability of comparable items. A prominent role is played by the high profitability of US FDI.

With regard to the sustainability of the US foreign trade position, however, that is precisely what raises doubts about the stability and reliability of the flow of income stemming from the yield advantage.

Last year, net investment income amounted to no more than US$7.4 billion, for example. There are many arguments to suggest that, in the United States, high positive net investment income is by no means guaranteed.

First, it has to be borne in mind that market position gains can soon be lost if the economic setting changes. The age structure or yield maturity of US and non-US FDI, which at present probably still differ in favour of the United States, may also converge in the medium term.

Second, the positive sign of the investment income balance conceals the fact that it has been falling steadily in relation to gross flows since the early 1980s. In 1980, it accounted for more than 40% of total US income from investment abroad, while, in 2005, it was less than 2%. This means that, today,

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[9] See ECB (2006), The Accumulation of Foreign Reserves, Occasional Paper Series No 43, February 2006.

[10] See Hausmann, R/Sturzenegger, F (2006), Global Imbalances or Bad Accounting? The Missing Dark Matter in the Wealth of Nations, Harvard University, CID Working Paper No 124, Cambridge MA.

[11] See Cline, W (2005), The United States as a Debtor Nation, Washington DC, sowie Gourinchas, P O/Rey, H (2005), From World Banker to World Venture Capitalist: US External Adjustment and the Exorbitant Privilege, presented at the NBER Conference on G7 Current Account Imbalances: Sustainability and Adjustment.

[12] See IMF (2005), loc cit.

comparatively small changes on the income or expenditure side can have far-reaching effects on the net income statement.[13]

Third, even with US investors enjoying constant yield advantages, an increase in borrowing costs could push US net interest income into deficit. Given the credit liabilities[14] of around US$3.6 trillion net shown at the end of 2004, a 1 percentage point increase in the global interest rate level over the entire maturity range would lead to an additional net interest burden of US$36 billion.[15]

That would be the case at least in the long run if the higher interest rate level affects all assets and liabilities. It would eat up the 2005 interest income balance, which was no more than US$7.4 billion.

In the final analysis, the "dark matter" theory does not provide a compelling reason why the USA and, with it, the world economy should be immune to risks of persistently large current account deficits.

V Implications

Coming to the policy implications, let me first note that globalisation by no means automatically gives rise to imbalances. In the past few years, what we have been dealing with is the advancing process of globalisation coinciding with a particular set of factors that have contributed to the emergence of global imbalances.

In this context, the close integration and increasing breadth and depth of the international financial markets have undoubtedly facilitated the financing of current account deficits.

Second, I would indeed like to acknowledge that the concepts behind the labels "global savings flows", "Bretton Woods II" and "dark matter" contain a number of components that can help us explain why the current account imbalances have not caused larger problems up to now.

Nevertheless, my comments are intended primarily to show that such explanations for what has happened in the past are not proof of the sustainability of current account imbalances in the future. But the prospects of a more equal distribution of global economic growth in my view do give hope that the necessary adjustments will gradually come under way.

Third, what is now crucial is that the process of adjustment is supported by an economic policy which ensures that a gradual and balanced reduction in the major imbalances really does occur. Simulations by international organisations all point in the same direction: Owing to the sheer size of the imbalances, it will be crucial for the adjustment to occur through several channels at once.[16] This is the best way to avoid extreme changes in individual variables and to ensure that any adjustment process is as orderly as possible.

The steps required include additional efforts to increase savings in the US, greater exchange rate flexibility in some Asian countries and reforms to strengthen the conditions for growth in Japan and, in particular, Europe.

With regard to the implications of the global imbalances for the euro area let me first emphasize that the external position of the currency union as a whole is more or less balanced. In 2005, the current account deficit amounted to US$ 28 billion (EUR 23 billion) or 0.3 % of GDP. Consequently, the role the euro area can play in facilitating the adjustment process is certainly rather limited. Nevertheless, enhancing long-term economic growth in the euro area is essential for internal reasons and simultaneously will contribute to reducing global imbalances.

Turning now to the policy conclusions that can be drawn for Germany, it is widely accepted that this necessitates structural reforms that are designed to restore consumer confidence and to increase incentives to invest. In my opinion, there are currently three policy areas at the top of the reform agenda: the labour market, health care and corporate taxation.

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[13] See Cline, loc cit.

[14] Excluding US reserve assets on the assets side and cash on the liabilities side.

[15] See Cline, loc cit.

[16] See OECD (2004), The Challenges of Narrowing the US Current Account, Economic Outlook 75, pp 151-168; IMF (2004), The Global Implications of the U.S. Fiscal Deficit and of China's Growth, World Economic Outlook, April 2004, pp 63-102; IMF (2005), loc cit.

With regard to the labour market, initial steps to create greater flexibility have already been taken. The reform of unemployment benefits and the extension of the qualifying period are a move in the right direction. Further efforts are needed, however, to increase individual firms' room for manoeuvre within the framework set by negotiated wages, and to lower the costs of additional employment by reducing non-wage labour costs.

Health care and corporate tax reform also have to be addressed in the near future. As I see it, the coalition government of Christian Democrats and Social Democrats should find adequate solutions which pave the way for more growth and employment.

Ladies and gentlemen, let me conclude by putting these specific suggestions for Germany into the broader context of how to reduce global imbalances, on the one hand, and the topic of this conference, on the other. These two days we have heard valuable contributions on *"How best to promote growth, employment and competitiveness in the European Union?"*, and we will hear more about this tomorrow. At the same time, your agenda shows exactly the way, how Europe could and should contribute to the reduction of global imbalances.