# Erkki Liikanen: Global rebalancing, asset prices and policy responses

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Fifth High-Level Seminar of the Eurosystem and Latin American Central Banks, Madrid, 10 December 2010.

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*Due to the strike and weather conditions the speech was distributed in written form.*

## Some background

Global imbalances are certainly not a new policy concern. The most visible manifestation of these imbalances is the large current account deficits and surpluses, but these are not the whole story. Current account positions reflect a number of deeper, more fundamental problems. Therefore, the inevitable future rebalancing has to involve deeper structural changes in the countries involved.

The risks caused by the global imbalances have been well documented in research and policy papers over the last ten years. Also, the imbalances have long been among the central agenda items in several international meetings. Most recent serious efforts to address them include the IMF-led Multilateral Consultations in 2006 and, today, the ongoing G20 Mutual Assessment Process.

Such rounds of discussions have successfully established a broad agreement over the key policy objectives to resolve the problem. At their simplest, these are remarkably straightforward. National saving needs to increase in the major deficit countries (such as the United States), and be reduced in the major surplus countries (such as emerging Asia and the oil exporting countries). It has also been acknowledged that for both deficit and surplus countries, meeting these objectives requires significant policy adjustments.

However, the multilateral initiatives to address global imbalances have so far suffered from an obvious lack of traction to actual policy outcomes. Since the onset of the global financial crisis, the imbalances have admittedly undergone a certain reduction. But recent projections indicate that the imbalances tend to persist – or even grow – well into the future. It appears that the imbalances have become an even more persistent characteristic of our economic environment than was previously thought.

## The nature of the imbalances

International surpluses and deficits are not, of course, harmful as such if they remain reasonable. They are a natural reflection of financial integration. They provide flexibility to savers and investors. By that, they are welfare enhancing. However, very large current account deficits, when persistent and growing, fuel concerns of external sustainability.

Two main risks to the international community have been extensively debated for almost a decade. First, sustainability concerns may lead to a sudden collapse of confidence in the ability of the deficit countries to maintain their external positions. The resulting disruptive adjustment would be harmful for the deficit and surplus countries alike and to the bystander countries as well. So far, this risk has not materialized and for the moment, the US bond markets do not seem to consider it particularly acute. The second risk is that the imbalances may give rise to tensions in global trade as well as exchange rate relations; this risk is materializing constantly, as witnessed in the run-up to the Seoul G20 Summit.

Beyond these two main risks, the financial crisis exposed a number of more subtle channels of transmission through which global imbalances undermine global economic stability. In particular, the enormous growth of financial intermediation and innovation, related to the imbalances, combined with regulatory weakness, has made the international financial system much too fragile relative to the accumulated risks. Also, the fragility of the international financial markets has led to a volatility of capital flows which may harm even fundamentally stable economies.

Easy and simplistic explanations of global imbalances have typically failed to stand the test of time. They may explain the most conspicuous developments in any one time period, yet fail to capture the multitude of relevant factors at play. It is therefore necessary to think of the imbalances as products of several fundamental factors, which lie deeper than the superficial level of macroeconomic policies. I will not go into these in great detail, but wish merely to mention a couple of rather general trends.

*The low pre-crisis national saving rates in deficit economies* were supported by low borrowing costs and the consequent asset price boom during the period of "great moderation". The low borrowing costs themselves reflected a number of reasons – from the "global savings glut" in emerging markets to failures in financial markets' risk assessments – and their relative significance certainly varies from country to country. But now, the economic structures of the deficit countries have adapted to the inflow of resources from abroad, and their internationally competitive sectors are smaller than they should be.

*The high saving rates in major surplus economies* are largely driven broadly by two key factors. Official sector savings derive largely from export-lead growth strategies based on asset-accumulating competitive exchange rate pegs combined with capital controls. Private sector savings for their part are motivated by structural forces, including demographic trends, the lack of developed social safety nets and a still underdeveloped financial sector that hampers domestic lending – and channels domestic savings abroad. Of course, in some commodity exporting countries, surpluses and official sector savings have been boosted by elevated commodity prices.

I would also like to emphasize the significance of the domestic policy contexts in the major deficit and surplus countries. As I mentioned in the beginning, the solution to the issue of external imbalances seems relatively simple if considered in isolation: just reverse the existing divergent trends in saving and investment ratios between the countries involved. It is important, however, to recognize that the global imbalances also reflect cross-country differences in economic structures and real resources, which give rise to differing policy interests.

## The post-crisis outlook for the imbalances

So what does the crisis imply for the evolution of the imbalances going forward? Here I wish to make a few brief observations.

On the one hand, the challenge of external rebalancing in the ***deficit countries*** has become closely intertwined with the internal rebalancing between public and private demand. Whereas the low saving rates in major deficit economies previously reflected large-scale private sector borrowing, the rapid decline in private spending after the crisis replaced private deficits with sizeable public sector deficits.

Too much of global demand and economic activity is now dependent on the fiscal deficits in the developed world. Therefore, the deficit countries here face a dual task: to rebalance the government budgets and, at the same time, to establish a growth-friendly economic environment that provides a sustainable foundation for the growth of private spending.

In terms of policy, one priority here lies in measures to maintain the availability of credit to the private sector, for example through repair and reform of the financial sector.

However, credit is not enough by itself. The growth of private demand must lie on a sustainable basis. In the deficit countries, future growth inevitably needs to rely increasingly more on net exports. This is a competitiveness question, but also a structural question. And this, of course, goes part and parcel with the objective of reducing the external imbalances.

On the other hand, recent events clearly demonstrate how the current crisis has increased the international pressure on emerging market ***countries with surpluses***. This was clearly apparent at the last round of G20 discussions, where foreign exchange issues were at the centre of the agenda. Undoubtedly, the problem has not gone away and will be one of the hardest issues also in the upcoming meetings.

However the exchange rate, the real exchange rate to be exact, is only a part of the adjustment mechanisms which can lead to a more balanced redistribution of economic activity and spending. In the end, the more the surplus countries can achieve through opening their markets, increasing competition, and diversifying their economies towards services, the less pressure will prevail on their exchange rates, and the smaller are the inflationary pressures they encounter.

So, orderly balancing is about structural changes in ***all*** affected societies, in deficit countries as well as surplus countries, around the globe. The political difficulty of making these adjustments happen is considerable.

## The roles of the euro area and Latin America

No matter how the eventual and necessary global adjustment will take place, it will have spill over effects that concern us all.

What unites the Latin America and euro area is the fact that global imbalances are not a problem of our own making. Both regions, taken as aggregates, have had broadly balanced current accounts and maintained flexible exchange rate regimes. But still, neither region would be immune to the spill over effects from a possible disorderly adjustment. And they would not be immune to the changes in relative prices which go together with an orderly adjustment, either.

It is this common role as exposed bystanders where the Latin American and European viewpoints meet, regarding the global imbalances. Policy makers in both regions worry about the danger of exchange rate volatility, and should think hard how to position their economies for the future, post-adjustment circumstances.

For the euro area, the challenges are threefold. There is the fiscal challenge you are well aware of; there is the challenge of increasing the productivity of the Euro area economies, especially in the countries with big external deficits, and there is the challenge of strengthening our financial system, which was so severely shaken by the crisis. Of these, I think the productivity challenge is the most fundamental in the long run, and much of the fiscal sustainability issue hinges on that as well. And without credible public finances, there cannot be a lasting solution to the stability of the financial sector.

Latin America for its part has already fallen victim to some of the fallout from global imbalances. Since the bust of the US asset price boom, the suppressed domestic demand coupled with near-zero interest policy has turned private capital to search for higher yield in the still-growing emerging markets. Latin America has painful experiences with excessive external indebtedness, and hence the prospect of large capital inflows causes understandable concern.

Under such circumstances of potentially disruptive capital inflows, capital controls have understandably become an increasingly attractive option for emerging markets trying to temporarily smooth the inflow of foreign capital, alleviate excessive pressure on the exchange rate and mitigate a build-up of risk in their domestic economies.

The debate over the desirability and effectiveness of capital controls is still ongoing and I do not wish to give definite advice on their proper role and scope. However, I do believe that financial development and innovation tends to make the maintenance of capital controls progressively more difficult and ineffective. And even as views on the controls have become more pragmatic within the international community, the historical experience thus far is mixed. It is safest to consider them as a temporary expedient, which cannot be relied upon to provide a lasting solution.

I would also note that a proliferation of capital controls can introduce potentially adverse distortions in the international financial system, which should not be ignored. Where necessary, the international community should therefore seek to establish common principles for their appropriate design. This is an area where the IMF policy advice and monitoring could have a greater role.

## Conclusion: addressing the problem

Finally, let me say a few words about how the problem of global imbalances could be constructively addressed. I will leave a more detailed discussion on this for the subsequent sessions of this seminar, but wish to highlight one observation that is relevant to what I have just said.

If deficit and surplus countries would choose to pursue policies based on their narrowest self-interests, seeking to postpone inevitable structural changes, the problems of global imbalances – and their adverse effects – would be likely to persist.

The only way to address the problem is international policy coordination. It is not enough to simply demonstrate that the imbalances ***can*** be addressed through an orderly, policy-driven adjustment. What is also required is a credible commitment from all key stakeholders to follow a cooperative approach.

As I see it, success in the latter requires two things. Partly, the commitment to a cooperative approach is a commitment to compromise. This can be achieved only through an open and direct interaction involving all key players. Despite its limitations, the G20 Mutual Assessment Process is the best tool we have for the task. Its mere existence has facilitated an exchange of views that was long lacking from international policy coordination.

But, and fortunately so, the necessary global rebalancing is not only about making compromises. The world economy is not a zero sum game, and better cooperation delivers real benefits to be shared. One needs to present a convincing enough a case – in both the major deficit and surplus economies – that the spillovers from globally inconsistent policies, are not in the interest of any country. This is certainly not an easy feat and will be a major challenge in the discussions going forward. The challenge is even larger because the solution involves so deep adjustments, not only in macroeconomic policies, but in the very economic structures of the countries involved.