# Axel Weber: Challenges to the global economy

Speech by Mr Axel A Weber, President of the Deutsche Bundesbank, at the European Banking Congress, Frankfurt, 18 November 2005.

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Ladies and gentlemen

## 1 Introduction

It is a pleasure and an honour to offer you some thoughts on current challenges facing the global economy. The European Banking Congress is always an appropriate forum for discussing global matters. This is especially true this year as the motto " Eurasia – Bull meets Tiger" addresses two of the most important players of the international monetary system.

Many economists tend to view globalisation as a basically benign phenomenon and take comfort in the fact that the global economy has been marked by robust growth and tame core inflation in the past few years. That is certainly true. But, on the other hand, we are witnessing several instances of possible imbalances:

- commodity prices have reached new record highs,
- yet government bond yields are low and corporate bond spreads and emerging market bond spreads are also low by historical standards,
- in some economies, low interest rates are fuelling housing price booms,
- additionally, the world economy is awash with liquidity,
- last but not least, global current account imbalances are at unprecedented levels.

With regard to that last point: The question of sustainability and the unwinding of the US current account deficit is crucial not only for the US economy itself, but also for the world economy. And it will have repercussions for Asia as well as for Europe. Especially as both regions are on aggregate largely dependent on external demand. For example, exports from emerging Asia have grown by more than 10 % per annum over the past decade. They now account for 45 % of emerging Asia's GDP. At the same time domestic demand has been subdued in most countries of the region.

## 2 Facts about global imbalances

Current account imbalances have widened considerably in recent years. The US deficit is at unprecedented levels. According to IMF projections it will reach over 6% (as a percentage of GDP) this year and next year. CEC countries will also exhibit significant deficits of nearly 5%. East Asian countries on the other hand are characterised by notable surpluses. Here current account adjustments in the wake of the Asian crisis have not been reversed. But the regional disaggregation makes clear that it is predominantly the Chinese external surplus which is driving the regional aggregate. Asian economies, excluding China, will – according to IMF projections – witness a significant shrinkage of their current account surpluses owing to higher import costs (from 3.8 % in 2003 to only 0.7 % in 2006). China, however, is projected to further widen its current account surplus from 3.2 % in 2003 to nearly 6 % in 2006. Finally, the euro area is in a roughly balanced position, although underlying national heterogeneity remains significant: Germany with a current account surplus of over 4 % in 2005 ( Netherlands nearly 5 %) and large deficits in Portugal (8.4%), Spain (6.2%) and Greece (3.9%). Owing to oil revenues, countries in the Middle East have moved into notable surplus positions over the past few years (even higher than Asian countries). In part, the increasing Middle East surpluses come at the expense of other regions. This is clearly visible in Asia (excluding China).

The US current account deficit is increasingly soaking up global savings, In 2005 the US current account absorbs more than 7% of global savings according to IMF projections. Given that savings are predominantly invested at home – although home bias has declined over the past years – these figures still underestimate the US influence on international saving assets.

Therefore, the topic of global imbalances is closely aligned to current account developments in the United States. This does not mean, however, that possible causes of global imbalances are purely an US phenomenon. And it does not mean that appropriate policy responses should be required only of the US authorities.

Nevertheless, it is the development of the US current account deficit that lies at the heart of widely discussed concerns among policy makers and economists. There is one reason for this: it is the question of whether the US current account trajectory is sustainable. And unsustainability, of course, means that "things that can't go on forever, don't" as Stein's law of policy reminds us.

### *2.1 Some brief remarks on sustainability*

For sustainability not to be more than just an empty phrase there is, of course, a need for an operable definition. Unfortunately, there is no universally accepted definition of an unsustainable current account. Economists who refer to it commonly use the theoretical framework of the intertemporal approach to the current account. The key message here is that a country must satisfy its intertemporal budget constraint: Judged against this benchmark, the sustainability issue for the US current account deficit is clear: with a negative net foreign asset position of USD2.5 trillion in 2004, the US economy has to produce trade surpluses some day in the future. In other words: a net debtor country cannot run trade deficits indefinitely – even if the debtor in case is the world's most potent economy.

This, of course, is a strictly theoretical analysis of the sustainability issue. A possibly more realistic approach defines sustainability as an unchanged net international investment position (in relative terms). Given the net external indebtedness of more than 20% of GDP in 2004, calculations imply a critical US current account deficit of slightly over 1% of GDP (far below the latest figures of 6% of GDP). Here, some qualifications because of valuation effects on the stocks of net foreign assets are in order. However, such qualifications do not change the basic message.

Nevertheless: this line of reasoning still does not give much practical guidance on the question of which relative net foreign asset position could be sustainable in the foreseeable future. On the one side, it would be unrealistic to expect the adjustment to lead to unchanged US net external indebtedness at current levels. On the other side, it is equally true that a net foreign asset position of the US economy amounting to over 100% of GDP – which is implied by the current trajectory – would mean a further step into uncharted territory carrying with it the risks of an disorderly unwinding with repercussion for the global economic and monetary system.

The bottom line of these considerations is: The current trend of the US current account is unsustainable with respect to different concepts and measures of sustainability. We should realistically expect a further increase in the net indebtedness of the US economy, but the current trend has to be broken in order to minimise unwelcome risks.

Therefore, it is not a question of whether, but rather of when and how the adjustment should come about.

An answer to these questions calls for an analysis of the causes of the current imbalances. This is of particular importance as different opinions about the ultimate causes imply different opinions about the likely stability of the current situation which is, of course, of prime relevance given the operational difficulties with the concept of sustainability for short-term policy purposes.

## 3 Arguments for and against the sustainability of the US CAD

At the risk of oversimplification, it might be helpful to distinguish three ways of defining the current account:

- Trade View,
- Savings/Investment View,
- Asset View.

Trade View: Cyclical and growth asymmetries between economic regions worldwide have contributed to the emergence of global imbalances. However, trade-related factors cannot explain the magnitude of the imbalances observed.

Savings/Investment View I: Global imbalances largely reflect low savings in the US (fiscal and private). The gloomy side of this perspective emphasises the widening fiscal deficits in the US and/or bubble-driven wealth effects in private consumption (housing market). The benign perspective focuses on a wealth effect rooted in higher US trend productivity growth resulting in higher risk-adjusted returns on US assets and correspondingly strengthened demand for US assets by foreigners.

Savings/Investment View II: Imbalances reflect structural changes in savings and investment patterns in other parts of the world. The most prominent advocate of the global savings glut hypothesis is the Chairman-designate of the Federal Reserve, Ben Bernanke.

Trade and asset view: Imbalances reflect more or less stable policy incentives – export-led growth strategies in Asia and reserve accumulation in the aftermath of the Asian crisis (Bretton Woods II hypothesis).

Asset View: Globalisation of financial markets reduces home bias and increases room for manoeuvre for financing of current account deficits. This position has been defended most prominently by the current Chairman of the US Federal Reserve, Alan Greenspan.

But let us be clear: Such isolated explanations may be helpful in highlighting certain aspects, but it should not be forgotten that, for a highly endogenous variable like the current account, the fundamental causes of the deficit affect goods and capital markets and a wide range of asset prices simultaneously. To quote Roger W Ferguson Jr on this (2005): "but any compelling explanation of the current account deficit must identify not merely the proximate influences on the deficit – be they exchange rates, capital flows, or aggregate saving and investment – but also the fundamental , underlying sources of the imbalance".

I do not want do go more deeply into the specific empirics of the US current account. Suffice it to say that, in my view, all these causes can explain certain parts of the US current account deficit – albeit at varying levels of importance:

Productivity increases generally prove to be significant explanatory variables for current account changes.

In general, empirical studies do not find much support for fiscal deficits having a very large influence on current account developments. This, of course, puts a question mark behind the popular thesis of "twin deficits". The US over much of the 1990s serve as an illustration (and Germany or Japan are also illustrative in this respect). However, for the past five years, the connection between the fiscal and the current account deficit seems to be closer for the US than most empirical studies would imply.

The ongoing integration of capital markets might have facilitated the financing of CA imbalances, too. There is empirical evidence that "home bias" has been declining over the past few years. But, in my view, one should not be too optimistic with regard to this channel. It is clearly not a panacea for the risks associated with the recent trend in the US current account deficit. Moreover, the process of deepening international financial markets – despite all benefits – entails its own risks: Inconsistent medium-term macroeconomic policy configurations might lead to marked shifts in investor sentiment and more volatile capital flows. In sum: Globalisation of financial markets has certainly helped to finance larger current account deficits than could have been imagined some decades ago. But it has not changed the fundamental nature of the adjustment process to international imbalances.

The "global savings glut" hypothesis definitely has some merits. However, I would like to stress that it should be understood as a "global net savings glut" hypothesis, as, besides changes in the saving behaviour, in particular low investment in different parts of the world seems to be crucial. One advantage of this argument is that it offers a possible explanation for the low level of real interest rates globally observed over the past few years. The proposition that it should better be understood as driven by low investment in surplus countries – especially in Asia – instead of excessively high saving rates is supported by developments in these countries: Investment rates in emerging Asia (excluding China) collapsed by nearly 8% of GDP in the Asian crisis. Since then the rise has been modest (+2% of GDP). Both private and public investment are still below pre-crisis levels. What should be taken into account, however, is that the pre-crisis investment level does not provide a suitable benchmark owing to earlier indications of overinvestment in the region. Moreover, the view that weak investment in the region is the more important factor is validated by empirical analysis showing that Asian savings behaviour is well predicted by traditional specifications, but investment behaviour is difficult to explain with the usual factors (WEO 2-2005).

The “global savings glut” or more precisely the “global net savings glut” argument has to be augmented by a description of the relevant transmission mechanisms through which global savings have been channelled primarily to the US economy. Ben Bernanke has elaborated on these mechanisms – something that is occasionally neglected in evaluating this explanation. Some of his findings are, that the relevant transmission channels have been asset markets: prior to 2000, the main driving force was equity prices (and exchange rates). Following the burst of the equity price bubble, real interest rates have been the main factor and housing markets and prices most influential. The linkage between housing market developments and the current account is no phenomena only of the recent past. As Alan Greenspan has emphasised, the stable long-term correlation between the US mortgage market and the current account could be observed over the past fifty years.

With regard to capital flows, there has been a marked shift from private flows to official flows (gross and net flows) in the past couple of years – with regard to capital inflows, however, there are some tentative signs that private capital flows to the US might have gained more weight again recently. Reserve accumulation by Asian central banks has been a major factor in this regard. Asian central banks de facto intermediate domestic savings into US assets. This has possibly helped to hold interest rates low and has fuelled a housing boom in some industrial countries, especially in the US, though, the the interest rate effect due to interventions and reserve accumulation is difficult to quantify. As a result, it has been possible to sustain robust demand growth in the US. This has been supported by significant fiscal and monetary stimuli.

The resulting configuration has been referred to as “global macroeconomic co-dependency” (Catherine Mann, 2005).

To that extent, the “global savings glut” argument is tight-knit to the Bretton Woods II hypothesis. And, here, I am quite sceptical as to whether this system can be sustained on a long-term basis. For just one reason: the financial needs – given the current trajectory of the US current account deficit – would be immense. They would expose the financing central banks to huge financial risks in the wake of a declining US Dollar. To be concrete: Since 2001 Asian central banks reserves have doubled. In mid-2005 they have reached a level of USD2.6 trillion. Roubini/Setser (2005) calculate that, if past trends continue, Asian central banks would have to raise their FX reserves to over USD5 trillion in 2008 – an annual increase of more than USD500 billion. Here, the current slow-down in reserve accumulation, which came to a virtual standstill in mid 2005, indicates that the latest move to greater regional exchange rate flexibility in Asia already has its measurable effects on reserve holdings, casting some doubts on Bretton-Woods II type explanations. In that regard, one also should not forget, that in the original Bretton Woods I system, the United States on average produced current account surpluses.

In a nutshell: The “global savings glut” argument may be an explanation for the development of the US current account deficit; but it is not convincing proof of sustainability in the long run. The same goes for the Bretton Woods II hypothesis.

Taking everything together: The current trend in the US current account deficit is unsustainable. This is hardly in dispute. Realistically, we should not expect the US deficit to move soon to levels that would stabilise the net foreign asset position of the US economy. However, the explanations advanced to explain why the current situation might nevertheless be stable for the foreseeable future all have their drawbacks and shortcomings.

As central bankers are paid for paying attention to risks, we should be aware that an abrupt unwinding of the current imbalances could mean massive exchange rate and interest rates movements – and, of course, a shake-up of the global economy.

We should obviously avoid the global economy following the lines described by the late Rudi Dornbusch. According to him, the collapse of unsustainable currencies and wrong-headed policies typically follows a cycle of four distinct phases: 1) enthusiastic investors and speculators chasing immediate short-term returns cause the anomaly to last for longer than economists expect, 2) puzzled by the failure of prices to return to fundamentals or the failure of unsustainable policies to generate a crisis, highly intelligent economists evolve theories explaining that “this” time it really isn't unsustainable, 3) fortified by these theories, yet more investors and speculators chasing short-term returns flood into the market, causing the anomaly to last for much longer than economists had originally expected, and finally, 4) the supply of greater fools comes to a sudden end; the crash comes; the crisis materialises.

## 4 Adjustment scenarios and policy responses

One should not forget, however, that current account adjustments in industrial countries historically are something different than balance of payments crises in emerging market economies. Accordingly, apocalyptic adjustment scenarios are not justified from the current perspective.

This is supported by recent empirical studies showing that the history of current account adjustments in industrial countries in the past does not validate the pessimistic hypothesis that goes along with an disorderly unwinding scenario (i.e. cumulative effect of shortfalls in GDP, massive currency depreciation and sharply rising interest rates). Finally, the US leads the global economy and the US Dollar is the reserve currency for the international financial system. Both factors are reasons to believe that the US can afford to finance larger current account deficits than other industrial countries.

Moreover, the current configuration is predominantly the outcome of very different decisions and actions by market participants. This limits the room for policy options and it may justify some trust that adjustment processes led by market forces will allow for a smooth transition to a more balanced world economy. But, given the uncertainty surrounding a purely market-led adjustment process, there is a justification for supporting policy responses.

Global imbalances are, by definition, multilateral in origin. This means that all parties have to step up their efforts to resolve imbalances. And numerous studies – including our own work at the Bundesbank – show that adjustment via different channels in isolation (growth differentials, exchange rates, US fiscal consolidation) would clearly not be of much help – unless the movements in the relevant variables attain either unrealistic or damagingly high magnitudes.

Two questions then remain: 1) How can adjustment be smoothed? 2) How can resistance to an (abrupt) adjustment be increased? The most sensible answer to these questions are, in my view, to be found in the well-known approach agreed at several IMF and G7 meetings: (a) US: increase in domestic savings, (b) Asia: more flexible exchange rate policies, (c) Europe: structural reforms.

Europe/Euro area

I will confine myself initially to the European case. And let me make clear: even if the current account position of the euro area is nearly balanced, this does not mean that the euro area has no role to play in the adjustment process. Like Catherine Mann (2005) has rightly argued: "that no other country faces as significant a quantitative change to their trade balance as the United States should not imply ease of adjustment. In fact, just the opposite could be the case as each country, facing the policy choices and structural challenges to reorienting demand, production, and financing, could argue that someone else should go first."

However, in my view the European role in facilitating the adjustment process is clearly more modest than the tasks for the other players, especially for the US itself.

There are two reasons for this: First, even if stronger growth in Europe is certainly something we all desire, the well-known smaller income elasticity of US exports compared with the import elasticity of the US economy (Houthakker-Magee-effect) means that the quantitative effect of higher European growth rates on the US trade balance will, in all likelihood, be modest. Second: even if higher potential growth is of the essence in the euro area and might be spurred by suitable structural reforms, the effect on the current account position of the euro area is anything but clear-cut. For one reason: Structural reforms have to be directed towards the non-tradable sector of the economy to improve the current account. For most of the currently discussed areas of reform – social security, fiscal policy – it is quite possible, that they will lead – at least in the short term – to increased savings in Europe. This, of course, would not help the adjustment to global imbalances – on the contrary.

So, all in all, the quantitative dimension of urgently needed structural reforms in Europe with regard to the adjustment of global imbalances will – in my opinion – be of secondary importance.

This does not mean that such reforms are not sensible in the light of risks associated with the current imbalances. There are, at least, two good reasons for this: they would enhance the flexibility and resilience of euro area economies in times when a smoother shock absorption capacity might probably be badly needed. And, of course, these reforms are urgently needed to improve the dismal potential growth performance in the euro area in general – and in Germany in particular.

In the euro area, the latest track-record with respect to growth enhancing policy measures has been disappointing. High public deficits and increasing government debt levels in the majority of member

countries have resulted in widespread difficulties to fulfil the commitment of the stability and growth pact. But it is empirically well-documented that solid public finances and low debt levels are important factors to support sustainable long-term growth. The sad fortune of the Lisbon agenda is another point in case. Finally: The controversy about the European service directive illustrates most visibly an ongoing lack to implement decisive structural reforms. Increased competition in the service sector, however, is just the type of reform that is needed on both grounds – strengthening growth for domestic reasons and supporting absorption for global reasons.

The question of decisive structural reforms is especially important for Germany – given its persistent weak growth performance and given the current political juncture. To be acknowledged: The starting situation for the new government coalition has been difficult and opposed interests needed to be reconciled.

The fundamental objective – improving long-term conditions for growth and employment and rehabilitating government budgets – deserves support. First steps in reforming the federalist structure, raising the retirement age, reducing subsidies and reducing social insurance contributions, are in particular, welcome.

But overall the actual outcome is unconvincing: fiscal consolidation is insufficient, especially with an eye on 2006. Subsequent to the coalition treaty a federal budget has been announced, in which the net borrowing increases. Moreover, net borrowing clearly exceeds the constitutional threshold. A justification for this along the lines of the constitutional provision enshrined in Article 109 GG – i.e. declaring a disturbance of macroeconomic equilibrium – is certainly highly problematic given the government's own assumptions for economic growth in 2006. This is certainly not strengthening confidence in the solidity of public finances. Economic conditions would have allowed smoother consolidation efforts over time with a more ambitious contribution already in 2006. Moreover, the contribution of expenditure led consolidation is modest; targeted measures focus on the revenue side. Historical experiences, however, show that revenue-based consolidations are the less successful and sustainable ones. In the consequence, credibility not only of national but also of European budgetary rules will be further undermined.

Finally, fundamental reforms in key areas have not been decided yet but are envisaged for the coming parliamentary term: these include income and corporate taxation, statutory health insurance scheme, financial constitution and increasing incentives to take on low-paid employment.

Against the challenges Germany is currently facing fiscal policy, labour market and social security reforms must remain on the political agenda.

Asia

Europe is currently "responsible" for less than 20% of the US current account deficit. Regionally disaggregated, Asia – including Japan – accounts for more than 50%. These mere figures emphasise, that for global imbalances, the US-Asian perspective is of major relevance.

The three-pronged approach to global imbalances advocates greater exchange rate flexibility in Asian economies. This broad perspective sometimes overlooks the fact that with respect to exchange rate flexibility Asia is anything but a homogenous entity. Some Asian currencies have undergone appreciations against the US currency which are comparable to those of the euro area. For example: In the period 1999–2004 the US dollar depreciated by more than 13 % against the Korean won (25 % against the New Zealand dollar and nearly 9% against the Japanese yen). In comparison: At the end of 2004 the US dollar had depreciated 9.5 % against the euro since the beginning of 1999.

And I have already mentioned that the aggregate regional perspective does not take due account of the fact that the short-term perspective for Asia's current account positions masks significant heterogeneity. Among the East Asian countries, it is China that heavily influences the Asian surplus position.

China has also been the most frequently discussed case with regard to inflexible exchange rate regimes. Here, the recent decision to adjust the renminbi's exchange rate regime was a welcome first step forward. Making further use of the potential flexibility of the new currency arrangement will certainly help to smooth the necessary adjustment process. It would also help to minimise the potential collateral damage to current imbalances, such as increased protectionism in some industrial countries.

Nevertheless, it should be borne in mind that, looked at realistically, more flexible exchange rates in Asia will also by themselves play no more than a partial role in this issue.

Taking the “global savings glut” argument seriously points to another potential role for Asian economies: strengthening domestic investment opportunities. From an economic point of view, it is indeed astonishing that developing economies are financing the savings gap in the world’s most advanced economy. Therefore, it is certainly necessary to improve investment opportunities in these countries to support domestic absorption (arguably with the exception of China, where investment rates have increased sharply and the private savings/investment balance is well below pre-crisis levels). This is equally important for endowing the young and expanding labour force in most of Asian countries with a modern and growing capital stock. In this respect, Asia (with the exception of China) has generally more favourable demographics than Europe.

With regard to reliance on external conditions Europe and Asia face the same kind of problem: Both the tiger and the bull show their strength predominantly outside their domestic habitat.

## Conclusion

Adjusting to current global imbalances will be the easier when all players stick to their responsibilities. Structural reforms in the euro area are, furthermore, in the domestic own best interests of our economies. The sooner they are implemented, the better. What will arguably be more relevant – and, thus, a necessary policy step in any orderly adjustment scenario – is increased exchange rate flexibility in certain parts of Asia. Improving investment opportunities in both regions is also of the essence. But it is certainly true: With regard to measures to reduce the current global imbalances the most urgent policy steps have to be taken by the US authorities.