Erkki Liikanen: Towards more balanced growth - past experiences and current challenges

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at a high-level seminar between the executives' meeting of East Asia-Pacific central banks and the Eurosystem, Frankfurt, 8-9 November 2005.

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- Looking at the world economy, one is struck by the pronounced differences in GDP growth rates of different countries and country groups as well as by the expansion of current account deficits and surpluses. Some of the rapidly growing economies, notably the USA, have had to face increasing imbalances. This has intensified concerns over worsening problems and how to manage them.

- As always, such unbalanced developments arise from a host of problems that are difficult to spell out. This is clearly reflected in the international debate concerning these problems. One must be wary of oversimplifying the problems and their solutions. Careful analysis of the problems will clearly help us decide on an appropriate policy strategy.

- Current account problems should be viewed from several different angles. The logic behind macroeconomic variables presents three fundamental perspectives from which to analyse a current account deficit:

1. Foreign trade and the services and income accounts of the balance of payments
2. The balance of savings and investment in the economy
3. Developments in the economy's external assets and liabilities

- Analysis is usually dominated by the foreign trade aspect, so that policy debate tends to focus on trade barriers and exchange rates. This is also typical of recent discussions of the US current account deficit and the surpluses of many other countries, particularly in Asia.

- It is important to examine the current account also from the perspective of savings and investment. Current imbalances in the global economy are largely due to the low level of savings and high level of consumption in some western economies, particularly the USA, and the abundant savings and modest private consumption particularly in several Asian economies. Recently, savings rates have also inreased sharply in oil-producing countries, with the boost in income from high oil prices.

- One should also emphasise the factors related to indebtedness and financial investment. By definition, the increase in an economy's indebtedness is the counterpart of its current account deficit. Often mentioned as determining factors in international capital flows are the depth of US financial markets and the US dollar's position as major reserve currency. These factors draw investment funds into the USA and so provide the financing for US domestic demand.

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- Of the three perspectives cited here it is savings and investment behaviour that is likely to get top billing in connection with the current imbalances. Europe, with its moderate level of savings, has been somewhat amazed by the lofty savings rates of many Asian countries and the low savings rate of the USA. Are Asia's robust savings rates fuelled by an authentic need to save or is this a case of weak consumption partly due, for example, to various kinds of regulations?

- The high degree of global saving has been prominent in recent discussions but, as voiced for instance by the IMF, the global savings rate has in fact declined in the last few decades. Apparently, the reduction has taken place mainly among households, so that the savings pendulum has shifted to the corporate sector. Corporate profitability has remained good in most countries, which is surprising, in the light of the heightened international competition. It may be that labour's pricing power has suffered even more from tighter competition due to globalisation than has that of companies.

- As a result, the problem – as well as the reason for the low level of international long-term interest rates – appears not to be a savings glut but rather an investment drought. This is partly because investment has shifted to "lighter" objects, where prices have declined, whereas the euro area especially needs more investment in equipment and machinery. This is because of the simple fact that new technology should be introduced swiftly. Given the low level of investment activity in the corporate sector, an abundance of financial resources has been channelled into the housing market, which has fostered sharp increases in house prices in many countries. As a result, households may have gotten into debt problems.

- Sluggish investment in the euro area in particular raises questions in a situation in which the factors that generally encourage investment are in place: Overall corporate profitability is good, interest rates are low, credit availability is good, and liquidity is abundant. A decline in capital-intensive production and a rechannelling of investment to countries with lower costs, such as the new EU member states, may have contributed to the low level of investment. Increasingly fragile demographics may be another reason for the subdued propensity to invest.

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- One way of addressing both the global imbalances and the low level of investment in the euro area is to boost productivity in the euro area service sector. Poor performance in the service sector is the main reason why euro-area productivity growth has been lagging behind that of the USA. Increasing competition is vital to improving productivity. Enhanced productivity would reduce service prices, which would support domestic consumption and ultimately boost investment to meet the new demand. This would also lead to an increase in imports. All in all, productivity growth would raise euro area economic growth towards that of the other major economic regions and would also help to correct the US external deficit.

- Using its GEM model, the IMF has evaluated the impact of more intense competition on economic development. Calculations show that enhanced competition in the goods, services and labour markets would have significant real-economy effects in the euro area. The impact would also be felt in the rest of the world economy. Calculations made using the Bank of Finland's Aino model have also produced similar results. Over the long term, increased competition in the product markets would stimulate the growth of consumption and investment.

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- Turning to Asia, several countries there have been running large current account surpluses. Developments in Asia resemble the strong reversal in Finland's current account experienced in connection with the deep recession of the early 1990s. Before the crisis, the Finnish economy was characterised by abundant but relatively ineffective investment and, as a result, a large and fairly persistent current account deficit. Following the crisis, capital usage became more effective and savings increased, and the current account moved substantially into the black.

- The reversal of Finland's current account can be attributed to several factors:
- improved price competitiveness due to a depreciating currency and modest wage increases
- more effective investment by companies and households
- consolidation of public finances
- investment abroad following the switchover to the euro (pension funds)
- reduction of interest payments due to a shrinking debt
- the major impact of Nokia and its exceptionally strong profitability

- What happened in many Asian countries was similar. Investment rates of the private sectors in particular declined after the crisis and have not returned to previous levels. As savings rates have remained stable or increased slightly, current accounts have moved into surplus.

- Countries with financial surpluses should also contribute to the equilibrating of the global economy. As in Asian countries, the surpluses have also increased in the oil-producing countries. They have thus far used their surpluses prudently, but most of them have a great need to use resources to further their own development.

- Some Asian countries are in a financial position where they could allow for higher consumption. This is particularly evident in China, where consumption accounts for an exceptionally small portion of GDP. The extremely high propensity to save in China has been explained largely by the low level of household wealth, lack of social security, and increasingly worsening demographics. To a certain extent, similar developments can also be seen in some other Asian countries. Consumption is, after all, the ultimate aim of economic activity. So far, Asia in particular has emphasised the importance of product manufacturing. But now the great need is for improvements in the provision of services. Improvement of market efficiency would seem to require an increasingly positive attitude towards imports of goods and services.

- It may still be possible, and to an extent necessary, to increase productive investment in Asia, because the current investment rates of some countries may be too low to maintain rapid growth. Good financial intermediation is important for both investment and consumption. It would enable efficient channelling of financial surpluses to the sectors that need them. This in turn would reduce companies' dependence on retained earnings for funding their investments, which may have contributed to compa-nies' high propensity to save since the Asian crisis. Well-functioning financial systems would be of particular benefit to small and medium-sized companies.

- The efficacy of the financial system also affects private consumption. As social safety nets are usually inadequate, households must prepare for ageing and other problems also via their own savings arrangements. An effective financial system would facilitate protection against risks and increase households' possibilities to even out their consumption over the life cycle. As population ageing progresses, these factors will become increasingly important.

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- Solution to global imbalances thus requires careful analysis of underlying causes. These are likely to be manifold. Addressing them calls for a multitude of measures in both deficit and surplus countries. Often the solutions to these problems call for structural changes in the product, labour and financial markets.

- In particular, it would be an enormous mistake to tackle current account problems by protectionist measures. Change in the global economy is in many respects unavoidable. Countries with high cost levels must give up part of their production, but this can be compensated for by producing high-tech goods, which the low-cost countries will need to enhance their production. Countries determined to carry out the necessary changes in a flexible manner – without resorting to import restrictions – will undoubtedly gain an advantage in the long run.