Kristina Persson: Globalisation, imbalances and possible ways forward

Speech by Ms Kristina Persson, Deputy Governor of the Sveriges Riksbank, at a conference on social economics, Stockholm, 3 May 2006.

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Thank you for the invitation to come here and speak on a topic that interests me very much, both in my role as representative of the Riksbank and privately, as a person with a strong interest in social issues. Let me begin by saying that I will not be talking about the current economic situation in Sweden. The discussion from the most recent monetary policy meeting will be published on 11 May.

I shall begin with a run-through of the opportunities and challenges that economic globalisation entails for a country like Sweden. I will then go on to discuss the imbalances that currently exist in the global economy, particularly in the exchange of goods, services and capital between Asia and the United States. The trade deficit is financed through the global financial markets, which are an important driving force in the globalisation process. Finally, I shall talk about some of the reforms currently being discussed within the International Monetary Fund (IMF).

Introduction

Ten years or so ago the word globalisation did not arise in the public debate, the term used then was internationalisation. The question is whether this indicates that something new has happened? My answer is that a number of political, technological and economic changes over the past 15–20 years have combined to bring about a more intensive phase in global economic integration.

The political changes can be summarised in the word deregulation, which has released flows of capital, goods and services across national borders. Trade barriers and customs duties between countries have declined.[1] The international capital markets were deregulated during the 1980s, which enables a free movement of capital towards investments that have the best return. Many product markets, particularly within the EU, have been opened up to competition. Large countries, such as China and India, which together comprise approximately one third of the world's population, are rapidly being integrated into the world economy. Following the breakdown of the Soviet Union, central European countries have joined the EU and adopted market economies.

Technological progress, particularly within the field of information technology, enables rapid and simple communication and money transfers from one part of the world to another, which makes it easier for companies to build up global trade and manufacturing networks. The cost of transporting goods between countries has also declined in recent decades, although the really major breakthrough in this field came earlier.

This has resulted in world trade increasing almost twice as much as GDP since 1985, direct investment has increased four times as much and the turnover in the global foreign exchange market is currently ten times larger than it was 20 years ago. Trade in goods and services now amounts to 5 per cent of the total cross-border currency flows, which can be compared with just over 30 per cent twenty years ago.

Globalisation entails increased competition, which leads to a higher degree of specialisation and benefiting from comparative advantages. Each country and region must dispose of its total resources so that they do what they are best at compared with others. This international division of labour means that resources are used more efficiently and lead to greater productivity in the world as a whole. This is not a new phenomenon; it has been going on for a long time. What is new is the deregulated capital markets which enable capital to move quickly across national borders, and the fact that many more countries now participate in the international trade exchange.

Since the 1980s, purchasing power per capita has more than doubled in the world as a whole. However, the increased welfare has not benefited everyone. The number of poor people, that is, those living on less than USD 2 a day, has actually increased by almost 300 million, to 2.7 billion people

[1] The average customs tariff in the industrialised nations fell from 6 per cent in 1989–1992 to 3 per cent in 2001.

during the period 1981-2001. A positive note is that the number of extremely poor people, that is, those with less than USD 1 a day to live on, has declined by almost 400 million. This means that 100 million people have moved to "stage 3", that is, marginally above the poverty line. There have also been major geographical changes in the spread of poverty. The number of poor people has declined in Asia, but increased in other developing countries. Africa South of the Sahara has fared the worst, with the number of poor people there doubling over the past 20 years. Over the past two years, Africa has enjoyed the highest GDP growth in more than 30 years.[2] So even there, globalisation may begin to have a positive impact.

China – an important force in the change process

China's entry into the global market economy has been one of the driving forces in the change process that the world economy is currently undergoing. The country's significance in the global world economy has increased at a rate and in a scope that few people considered possible a few decades ago. Since the reform policy began at the end of the 1970s, average growth has been 9 per cent a year. China has accounted for one third of the world's real growth in recent years. The country has rapidly transformed into the second largest economy in the world, become the third largest trading nation and one of the largest recipients of foreign direct investment.[3]

The strong growth in China has been driven by investment and exports. Investment comprises just over half of GDP, which is much higher than the shares in OECD countries or in other rapidly-growing economies. The high level of investment has been almost entirely financed through domestic savings. The saving ratio in China amounts to around 45 per cent of GDP, which is a much higher level than in most other countries. According to estimates, Chinese households save one third of their incomes. One reason for the high level of saving is the lack of a social safety net and a general pension system. As a consequence of the high level of saving, private consumption is relatively low. China has had relatively strong growth in exports; in the past five years alone exports have trebled.[4] The country is currently a nation as open as, for instance, France and Italy, measured in the percentage of foreign trade in GDP and considerably more "open" than the United States.

China has come to be called "the factory of the world" as an increasing number of foreign companies have chosen to purchase goods and locate parts of their production there. For instance, China manufactures more than two thirds of all photocopiers, microwave ovens and DVD players, and 40 per cent of all of the world's computers.[5] However, a large part of the input goods for these products are imported from neighbouring countries, but the prevalent picture that China can only compete with low-cost products is slowly changing. In recent years China has gone from specialisation in simple, labour-intensive low-cost products to also producing more technically-advanced and internationally-competitive products. The Chinese authorities conduct an active trade and industry policy to build up the domestic industrial and technological capacity, for instance in the fields of telecommunications, energy, motor vehicles and pharmaceuticals. Their goal is to have 30-50 Chinese countries among the world's 500 largest within 5-10 years. In addition to investments in research and development, China's human capital has also been reinforced by an increasing return flow of highly-educated Chinese who have now begun to return home after studies abroad.

The rapid developments in China have so far mainly occurred in economic free zones along the coasts and in adjoining areas. In rural areas, where the majority still live, poverty is widespread. The uneven distribution of growth has given rise to social tensions, which risk slowing down developments in future. The Chinese authorities are facing major challenges in terms of increasing private consumption and dealing with the growing income gaps. Environmental pollution is another major problem, as is the lack of human rights. The financial system in China is also under-developed.

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2 GDP increased on average by around 5 per cent during 2004 and 2005.

3 All of the figures and comparisons here are made in PPP terms, that is, taking into account purchasing power differences and differences in price levels.

4 However, a large part of China's foreign trade consists of input goods that are imported from neighbouring countries, assembled in China and then exported elsewhere.

5 The Economist 2004-10-02.

Globalisation involves both challenges and opportunities

The increasing competition from, for instance, China, India and eastern Europe means that there is increasing pressure on the early industrialised nations to transform their trade and industry structure. This structural transformation will affect people, places and regions in different ways. However, history shows that free trade and increased economic integration lead to increased economic welfare for the world as a whole. The international division of labour that follows in the wake of globalisation leads to lower production costs and productivity gains, which in turn means that labour and investment in the industrialised nations can be moved to other sectors with more refined products and services. In that sectors and companies that are not internationally competitive are knocked out, scope is created for new employment in areas where different countries and regions have comparative advantages. However, for an individual country or region to benefit in this process, the “creative destruction” entailed in the structural transformation must lead to new jobs with a higher value added factor being created at the same rate as the old ones disappear.

Effects on the labour market

China’s and India’s integration into the world economy is sometimes described in the debate as a supply shock in the global labour market, which will result in rapidly-falling wages in the western world.[6] However, the expansion in exports in China has been made possible by the fact that production per worker has increased, rather than by a dramatic increase in the amount of labour.[7] The "supply shock” is the result of modernisation and industrialisation, i.e. that workers who are not very productive move from an old-fashioned structure of collective agriculture and state-owned companies to modern companies that produce goods for export. The effects of this development on the labour market and on real wages in the west will depend on how the exchange of various types of traded goods develops and how this in turn affects relative prices.

Globalisation could certainly entail downward pressure on Swedish real wages, but both data and historical experiences so far indicate that this is not the case. At least, there is nothing in the statistics to indicate that there has been any deterioration in industrial nations’ trade conditions towards either China or other Asian countries. In the long term, Swedish and Chinese wages will probably converge, but this does not necessarily mean falling real wages in Sweden. It is particularly those with no higher education who risk experiencing pressure from the new industrial nations, but a general reduction in real wages does not appear very likely. Sweden has been exposed to international competition for a long time without suffering any deterioration in our welfare, and over the past 10 years we have had rising real wages, despite the expansion in China.

However, it is likely that the distribution of income will be affected in terms of growing gaps between those with and without higher education. Wage shares have fallen in many countries, without any real explanation, while profits in the OECD area have been at an all-time high. Technological developments have led to both increased profits and increased demand for highly-educated labour in relation to less qualified. The possibility that increased competition from low-wage countries could be part of the explanation cannot be entirely ruled out.

However, there is no support in the statistics to say that economies that are more dependent on foreign trade have higher unemployment than others. It is rather the other way round; that increased trade often goes hand in hand with lower unemployment and higher welfare. The rapid market growth in such large countries as China and India means that demand for goods and services produced in the old industrial nations increases.

The investment in research and development in China and the transition to increasingly advanced production does not mean that "all jobs” will move there. Experiences from Europe’s trade exchange with Japan and Korea in recent decades indicates a different development. There one can see that an increasing percentage of trade has developed to become what is known as inter-sector trading, that is, one exchanges goods with one another that are produced using roughly the same technology. Welfare increases in that there is greater variety in the supply offered to consumers and companies can benefit

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6 Persson, M. and M. Radetzki, "China, Sweden and globalisation”, *Ekonomisk Debatt* 1, 2006.

7 Bigsten, A. and B. Holmlund, ”Exaggerated fears of the threat from China”, *Ekonomisk Debatt* 2, 2006

from economies of scale in their production. There are many indications that the trade with China and the other rapidly-growing economies are developing in this direction.

How will Sweden meet the challenges?

So far, it appears as though Sweden has managed the structural transformation well, although some groups and regions may experience negative effects during a transitional period. The Swedish Institute for Growth Policy Studies (ITPS) demonstrates in a study that Swedish-owned industrial companies which increased the number of their employees in low-wage countries during the 1990s at the same time showed an increased demand for labour force with higher education back home in Sweden. This is in line with the development that has taken place in the United States and the United Kingdom. According to the Swedish Labour Market Administration's figures on redundancy notification and ITPS's media monitoring, few jobs moved abroad as a result of companies transferring their operations abroad during 2005. In total, the number of jobs was 2,000-4,000, of which 1,500 involved a move to another EU country.

The major challenge for the future lies not in the number of jobs moving abroad, but in managing the transition required to make it possible to create new jobs as new employment is created mainly in other countries/regions. This requires a good corporate climate, a good capacity to attract knowledge and capital and an ability to transform, including flexibility in the labour market so that employees can apply to new sectors and areas as smoothly as possible. If this is not successful, there is a risk of growing structural unemployment.

At the time of the extensive structural transformation in the 1970s, the public sector took in many of the new entrants on the labour market and those who lost their jobs. This possibility is no longer available to the same extent. Instead, it is the private service sector that will have to expand. In a sparsely-populated country like Sweden, however, labour market matching can be particularly problematic as many service companies require proximity to population centres in order to be profitable.

A key issue in future will be how we can attract capital to invest in Sweden. Regarded in this perspective, the falling investment ratio in recent years provides cause for concern, although there was a recovery last year. Sweden currently has a large trade surplus, but many of the large Swedish companies choose to invest their export income abroad. Swedish investment in foreign countries amounted to approximately SEK 200 billion in 2005, while Swedish industrial companies' investment in foreign debt securities increased by almost SEK 70 billion. The capital inflow during the same period was approximately SEK 100 billion.[8] According to Swedish companies, one of the main reasons why their export flows remain abroad is that expansion in new markets and new production capacity occur mainly abroad and not in Sweden.[9] The fact that an increasing share of direct investment is aimed towards emerging economies in South East Asia is part of an international trend that can be seen in most OECD countries.

It can be assumed that the effects on the world economy of the integration of, for instance, China and India, will continue for some time to come. There is a long way to go before the whole of China is included in the global market economy. However, it has recently been possible to see some inward movement within the country as wages have risen in the coastal regions. Nevertheless, there still remain many hundreds of millions of poor people in China who are prepared to take jobs with very low remuneration compared with the wages paid in Sweden, for example.

One effect that is of significant importance to the Riksbank is lower prices in international trading. The low inflation in Sweden over the past years can be explained by low import prices and high productivity. The latter is also connected with globalisation through the increased competition and changes in production patterns.

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[8] However, the value of foreigners' assets in the form of direct investment in Sweden is high from both a Nordic and a European perspective. Foreign direct investment in Sweden amounted to around 47 per cent of GDP in 2004, which can be compared with just over 30 per cent in the EU.

[9] ` SEB, "Kronsyn", 22 March 2006.

Globalisation and imbalances in the world economy

The deregulated international capital market has meant that countries have to a much greater extent than before been able to finance consumption and investment via borrowing abroad. This could indicate that trade imbalances are something we have to live with in a world with deregulated capital markets and a greater degree of free trade than before. At the same time, risks of rapid adjustments may be built up.

In connection with the slowdown in economic activity in 2000-2001, US economic policy was shifted in a more expansionary direction. Income tax was lowered and public expenditure increased, at the same time as the key rate was cut to an all-time low. This entailed a strong increase in demand, which also stimulated exports in other countries – the United States acted as growth engine for the world economy. The consequence of this was that the US current account deficit increased rapidly; in 2005 it amounted to 6.4 per cent of GDP. The driving forces behind this were a budget deficit that amounted to 2.6 per cent of GDP in 2005, and a large and growing deficit in household saving. Private household saving turned negative in 2005, which was the first time since the 1930s and corresponded to 0.3 per cent of GDP. The US current account deficit is counterbalanced to 40 per cent by the surplus in Asia, particularly China and Japan. The remainder is accounted for by a number of oil-producing countries and a few small, open economies, including Sweden, Norway and Switzerland.

Several different explanations have been put forward for the large US current account deficit. The explanation most often highlighted in the United States is that the deficit reflects stronger productivity growth and higher growth potential in the United States, compared with other parts of the world. Many of the investments made in the 1980s and 1990s, particularly IT investments, had substantial positive effects on productivity, after some time lag. When these investments were supplemented by reorganisation and internal training within the companies, they had an even greater effect on productivity.

The labour supply has also benefited from substantial labour immigration. According to the OECD, potential growth, that is, how fast the economy can grow without problems arising in the form of overheating, amounts to 3.4 per cent in the United States, with around 1 percentage point being explained by the labour supply.[10] The corresponding estimate for the euro zone is 1.9 per cent and for Japan it is only 1.3 per cent. The relatively better growth prospects have meant that many investors have chosen to invest their capital in the United States, where the expected return is higher than in, for example, Europe. This has led to a capital flow that has strengthened the dollar, which has contributed to reducing net exports and thereby increasing the current account deficit. Expectations of increased income have also contributed to subduing saving by US households.

Another explanation is that the deficit is a result of the domestic policy in the United States. The expansionary economic policy has contributed to reducing saving both among households and in the public sector, which has stimulated consumption and growth.

A third explanation points out Asia's structural saving surplus as the driving force behind the imbalances. Private saving is generally at a high level in Asia. This applies in particular to the emerging economies, but Japan also has substantial private saving. Following the financial crisis in Asia in 1997, there was a correction of the earlier investment bubble, and the investment ratio fell from very high levels. The exception is China, where both saving and investment have increased substantially.

The increased saving has to a great extent been invested in US bonds, which has pushed down long-term interest rates in the United States an further stimulated US household consumption. Approximately two thirds of saving in the world is currently channelled to the United States. Many Asian central banks have brought dollars that are invested in US government bonds in order to prevent their own currencies appreciating against the dollar, which would reduce their competitiveness. China, in particular, has been strongly dependent on exports to maintain a stable increase in employment and thereby to avoid even higher unemployment. This has meant that the foreign exchange reserves in Asia have increased dramatically in recent years. The consequences of the saving have been that household consumption has been kept down and the increase in welfare has not been as large as it could otherwise have been.

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[10] OECD, *Economic Outlook*, No. 78, December 2005.

In my opinion, all of these factors depend on one another and altogether they provide an explanation of the US deficits and the global imbalances.

Are the imbalances sustainable in the long term?

Although opinions are divided as to the seriousness of the US current account deficit and the main explanations behind it, most analysts agree that there must be a correction sooner or later.

Some claim that the sustainability of the US current account deficit is greater than many have earlier believed. They point out that there has been no correction so far, despite the fact that the deficits have remained high over a long period of time and that the dollar has even appreciated over the past year. One argument in favour of the trade imbalances being sustainable is that the higher growth in GDP and income from foreign ownership in the United States make it possible to continue to finance interest expenditure on the foreign debt. The reform process for increasing potential production in Europe and Japan is still proceeding slowly, which could indicate that growth differences will remain for some time to come.

Other people, including me, consider that the imbalances comprise a serious risk to the world economy and that the longer they remain, the greater the risk of negative effects arising from a correction. The most probable scenario in the near future, according to the Riksbank and most other analysts, is that there will be an orderly, gradual correction of the imbalances with manageable effects on the world economy. In the long term, demographical factors, such as a larger percentage of elderly people in the population of the rapidly-growing Asian countries, also argue in favour of a correction taking place in the form of reduced private saving.

However, one cannot rule out the possibility of a more abrupt adjustment of the imbalances, which could have considerable negative effects on the world economy. There are two possible scenarios that could trigger a more abrupt adjustment. One is that the US households choose to rapidly increase their saving, for instance, out of worry over future financing of general government healthcare and the pension system. A slowdown in saving could also trigger a fall in house prices, which could in turn further reduce saving. The second scenario could be that investors change their perception of potential growth in the United States and the growth and income advantage which one previously thought would persist. This would mean that interest expenditure on the foreign debt could be perceived as untenable and trigger rising interest rates and rising costs for the US foreign debt.

In both of these scenarios there is a slowdown in growth in US consumption, which could have major effects on global economic activity. One can also imagine that an international economic slowdown would be reinforced by a fall in house prices and a change in the view of the United States as a borrower, which could lead to an abrupt slowdown in the world economy.

The global imbalances and the threats to jobs from the increasingly stiff competition have triggered increased demands for protectionism, both in the US congress and in Europe. A downturn in the world economy could trigger a wave of protectionist measures, such as trade barriers and customs tariffs, which could further worsen an economic downswing.

For a small country like Sweden that is dependent on foreign trade, an abrupt adjustment of the imbalances could have a severe impact on the economy. A rapid fall in the dollar rate would probably be followed by an upturn in the euro, which could push down European companies' competitiveness and slow down growth in the euro zone. This would subdue growth in Sweden, which has around 40 per cent of its exports to the euro countries.

Conclusions and ways forward

It would be wrong to say that globalisation is a force of nature that cannot be stopped. However, it would be very costly for an individual country or region to try to remain outside of this process. This alternative does not really exist in practice. That applies in particular to a country like Sweden, which is small and strongly dependent on foreign trade, and integrated with the outside world. At the same time, globalisation brings new demands and challenges. Many of these require global or regional solutions.

There are thus two additional paths to take: One is that society and the business sector try to manage the changed conditions that globalisation involves in the best way possible, and one is that Sweden together with other countries/organisations actively works to promote regulatory systems, infrastructures, foreign aid and cooperation in the fields that require widespread support. This applies in particular to the global imbalances I have described here.

Mobilisation of resources

In the domestic field, the challenge for Sweden in future is to develop and renew the business sector so that we can meet the increasingly stiff competition. The general government and local governments will probably be unable to create very many new jobs; Sweden's demographic situation means that taxes will be used to maintain the level of service and transfers that already exists. What the public sector can do, is to create good conditions for innovation, entrepreneurship and an efficient labour market.

In an open world economy, it is not only companies that compete with one another; places, regions and countries all compete to attract labour, top competence and investment capital. Growth is a necessary condition for increasing welfare and it is only more work and better use of time/working hours (productivity) that create growth. Research and development, investment in innovations and increased efficiency that liberate resources for more productive purposes are a necessary condition for production to be able to manage to increase in value and to survive in competition with 'low-cost' countries.

However, not everyone will be able to, or need to, work in branches exposed to competition. Large areas of private consumption, notably education, healthcare, care services, personal services, trade in non-durable goods, etc. benefit from local anchorage. Many of the new jobs will in future be in this field. Creating good conditions for the growth of the service companies is therefore an important element of a policy to manage the challenges of globalisation.

Mobilisation of resources and the promotion of creativity usually assume cooperation between different interests, within politics, the business sector and academia. Sweden has well-developed traditions to build on, this applies in particular to the local and regional work on developing the business sector.

Global policy

Globalisation creates the conditions for increased growth and welfare, but entails greater risks in terms of the threat to the environment, access to strategic commodities, security and a growing mutual dependence. Globalisation must therefore be matched by cooperation between countries and regions. It is my conviction that we will need an increasingly international political cooperation to be able to manage the downside of globalisation and to reduce the economic gaps in the world.

With regard to the risks related to global imbalances, there is an organisation that was given the role, back when it started more than 60 years ago, of monitoring global financial and economic stability: the International Monetary Fund (IMF), which was formed to provide temporary balance of payments support to its 45 western member countries.[11] Since then there have been major changes in the world economy. The number of IMF member countries has increased to 184, the fixed exchange rate system has collapsed and worldwide capital markets have been established. The IMF's lending has declined from approximately USD 60 billion in 2003 to around USD 20 billion in 2006, which also entails a major reduction in the income that has so far financed the organisation's activities.

At present, there are intensive discussions within the IMF and its member countries as to how the organisation should be reformed in order to better meet the needs and problems of a new age. At the recent 2006 spring meeting, the member countries supported a proposal that the IMF should be given the task of acting more powerfully to correct global imbalances and other threats to financial and economic stability. Today's threats and risks can largely be found in the interaction, or perhaps the lack of it, between the politics conducted in different countries/regions. Examples here are China's exchange rate regime, the US current account deficit and the EU's agricultural policy.

The proposal involves the IMF being given a stronger regional and global monitoring role and the possibility to call countries to multilateral consultations. The Fund's older task of monitoring exchange

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[11] The Soviet Union and its satellite states were invited to take part, but the regime of the time rejected the offer of membership. Czechoslovakia took part in the IMF from its inception, but was forced to withdraw from the cooperation.

rate developments in particularly systemically-important and large growth countries is also being given a more prominent role.

It is also observed in the reform proposal that efficient supervision is not merely a question of correct analyses and high quality advice. It is at least as important to communicate the analysis in a manner that creates confidence and means that the advice is followed. To achieve this, a new communications strategy is proposed, which is based on openness, transparency and a more intense dialogue with society as a whole. This should increase understanding among the population for implementing necessary measures and put pressure on governments to do so. Every other year, a special Globalisation report will be produced. This will contain a more in-depth version of the annual analyses of global financial and economic stability.

One very important question for the Fund's legitimacy and ability to act is how it is governed. Today the governance of the IMF to a large extent reflects the distribution of power in the world when the IMF was established. The question of influence and governance has gained a new explosive force through the economic developments in a number of large growth economies such as China, India, Brazil and Mexico, who now demand greater influence.

If nothing is done to reform the IMF's forms of governance, there is a risk that the organisation will lose legitimacy and relevance. It will most likely take time before a sustainable solution has been drawn up. Personally, I regard the regional principle as the most democratic and efficient in the long term. This would mean that the large regions – which are currently more or less well-organised - the United States, Latin America, Europe, Africa, Asia, etc. - reinforcing there regional platforms in order to shoulder global responsibility together.

Thank you!