François Villeroy de Galhau: External imbalances - challenges and policy responses

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the "Financial Globalisation" conference, Central Bank of Ireland Symposium, Dublin, 2 February 2018.

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Accompanying slides

Speech elaborated with the contributions of Antoine Berthou, Matthieu Bussière, Laurent Ferrara, Sophie Haincourt, Francesco Pappadà and Julia Schmidt

Ladies and Gentlemen,

First and foremost, I would like to congratulate the Central Bank of Ireland on the 75th anniversary of its creation, and especially my colleague and friend Governor Philip Lane. I am delighted to be part of this conference dedicated to "Financial Globalisation", with such distinguished speakers and panellists.

I would like to share with you a few thoughts on global current account imbalances and in doing so I will take mostly a policy perspective. The stylised facts are well known so I will be brief [Slide2]. Starting from the late 1990s, the world economy was characterised by very substantial growth in global current account imbalances. Despite a process of rebalancing and short-term movements mainly related to commodity prices that started with the Great Recession in 2008–09, these imbalances have remained large and persistent. Consequently, net international positions have continued to increase [Slide 3]. The euro area is one of the regions where developments have been particularly striking [Slide 4]. Although countries such as Spain or Italy have rebalanced their current accounts, imbalances still persist, mostly due to the large surpluses of Germany and the Netherlands.

But why should we care about these imbalances? After all, there is no reason why all countries in the world should be balanced at all times, as these imbalances simply reflect the need for funding current or future consumption and investment. **However, excessive external imbalances may become a source of concern**because the funding of deficit countries by surplus economies is subject to "sudden stops" and even reversals.[1] Experience suggests that large imbalances are often a leading indicator of subsequent crises and sudden stops. As shown by Philip Lane in one of his numerous contributions to this topic,[2] current account balances prior to the Great Financial Crisis exceeded levels consistent with underlying economic fundamentals and thus implied large and costly adjustments thereafter. These vulnerabilities are not confined to emerging market economies: large and persistent current account deficits may also precede financial crises in advanced economies,[3] including in the euro area.

I will structure the rest of my talk as follows. First I will talk about the determinants of the current account, focusing on the role of the exchange rate. In the second part I will say a few words about the composition of external funding (gross and net capital flows). Finally **I will conclude with a discussion of available policy options** that could address the persistence of current account imbalances, globally and within the euro area.

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1. The determinants of global imbalances, and their adjustment mechanisms

The economic and social costs of correcting current account imbalances are potentially dramatic. The macroeconomic effects of a transfer of resources from debtor to creditor

countries is an old issue, going back to the debate between Keynes and Ohlin about Germany's international obligations after World War I. In recent decades, Maury Obstfeld and Ken Rogoff[4] have pointed out in a series of papers that the basic mechanism of the adjustment results in a transfer of real resources from debtor countries to surplus countries, regardless of the drivers of global rebalancing.

In the debtor country, there is a clear macroeconomic cost related to a drop in domestic spending and welfare, leading to large negative output gaps and high unemployment rates, and in turn putting strong downward pressures on wages. This is typically what we saw in the euro area, where the adjustment contributed to the very different dynamics of unit labour costs across countries [Slide 5], and therefore led to relative price adjustments. In cumulative terms since 2007, Germany has seen real exchange rate appreciation of about 8% relative to France, and 20% relative to Spain, although we should take into account in these dynamics the large gains in German competitiveness before the crisis. The adjustment relied mainly on nominal adjustment in deficit countries.

The link between **the current account and the real exchange rate** is still subject to considerable debate among academics. If we look at a simple scatter plot showing how current account variations and real exchange rate variations have been related since the early 2000s [Slide 6], the conclusion is quite pessimistic: over this period, yearly variations in the real exchange rate have only been weakly negatively related to current account adjustments. One interpretation, however, is that a rebalancing requires large real exchange rate variations and therefore implies large costs in terms of welfare for deficit countries. In addition, this relation may differ a lot between the "build-up" periods of global imbalances and periods of "rebalancing". If we split the sample into the period before and after the "peak" of these global imbalances in 2006 [Slide 7], **there is indeed a clear asymmetry:** current account variations were more strongly related to real exchange rate movements in the four years following the "peak" (rebalancing period) compared to the four years before the peak in global imbalances (build-up period). There are many reasons why this relationship could change over time: for example it has been shown on the export side that very productive exporters react less strongly to real exchange rate movements than small and unproductive exporters.[5] This means that when there is a need for rebalancing, a lot happens through the import side and, in deficit countries, through demand compression.

2. The funding of large imbalances

Let me turn now to the financial side of the current account and discuss the sustainability of excessive current account imbalances, focusing mainly on the level and composition of the funding.

Large current account imbalances, in particular deficits, pose significant risks for external debt sustainability and raise the possibility of sudden stops.[6] Gross positions are now 3 to 4 times larger than their 1995 level, ranging from 150–300% of GDP (150% in the case of the US and 300% in the case of France, for example). Net positions are considerably smaller [Slide 8, table on right-hand side], but have widened by a factor of 5 to 10 with respect to their level in 1995.

The counterpart of persistently large current account imbalances is large net external asset positions [as already shown in Slide 3], but also continued accumulation of external assets and liabilities.

In this respect, the **composition** of the financial account (FDI, equity and debt portfolio flows as well as the other investment category, which largely comprises banking flows) matters. Examining the different financial instruments, one notices that the volatility in overall flows is largely driven by banking flows [Slide 9]. Given the large pre-crisis expansion in cross-border banking flows, especially within the euro area, the "low" level observed in recent years could

simply be interpreted as a return to normal. Indeed, in the aftermath of the Great Financial Crisis, banking flows retrenched the most, followed by debt portfolio flows.[7] Portfolio equity flows have been much more resilient than debt flows, which have halved between the pre- and the post-crisis periods. The resilience of equity flows shows that they have better risk-sharing properties than debt.[8]

So, even though important measures are taken to reduce trade balances (sometimes at a high cost), the way these current account deficits have been financed continues to impact current and future current account imbalances, thus limiting the efficiency of demand rebalancing. Valuation effects and income flows are increasingly driving net external positions, more than the trade balance itself [slide 10]. This implies keeping a close eye on the types of financial flows which finance current account imbalances, and watching out for the relative contribution of FDI, equity, debt and banking flows to the build-up of external imbalances as well as the exchange rate exposure both on assets and liabilities.

3. So what are the possible policy responses to limit excessive global imbalances?

Let me start by stressing what the non-adequate responses are. First, protectionism is a temptation but it is not an option. From a macroeconomic point of view, an increase in protectionism is recessionary and inflationary, acting as a negative supply shock. Furthermore, as the current account is determined by the balance between savings and investment, there is no clear evidence that trade policies are likely to affect both variables. For example, due to the increasing integration of global value chains, any increase in tariffs on imported inputs immediately translates into higher production costs, thus undermining export competitiveness. So, imposing new trade barriers – or “bilateral deals” – on some trade partners not only has almost no chance of eliminating the overall current account deficit, but it also threatens long-run economic growth.

Alternatively, it would also be misleading for countries to carry out non-cooperative domestic macroeconomic policies. Competitive devaluations first: after some unilateral and unfortunate declarations last week, several of us on the Governing Council of the ECB felt the need to reiterate that during the last IMF Annual Meetings in DC last October we committed with all our partners to a multilateral approach saying that, I quote, “we will not target our exchange rates for competitive purposes”. Any deviation from this common rule would be at the cost of breaking mutual trust and global growth.

Speaking of the Governing Council of the ECB, let me say a few words on our monetary policy. It is following, with confidence and with patience, a path of gradual normalisation. But one shouldn’t focus excessively on the sole instrument of monthly net asset purchases: whether we end them in September or taper them somewhat more gradually is not a “deep existential” question… There are two more important issues:

- First, we prefer, as in Irish dancing, a four-hand reel rather than a solo; we will rely more and more on the entire policy package, including the sizeable stock of acquired assets, the forthcoming reinvestments and the forward guidance on interest rates. And we will follow a predictable sequence.
- Second, the timing of this sequence will depend on the inflation outlook and its progress towards our target of close to but below 2%. We will accordingly monitor the impact of the exchange rate evolution – which is a source of uncertainty –, and be ready to reassess if necessary.

Fiscal devaluations have also been considered by countries aiming at boosting competitiveness through changes in their tax system, typically by cutting labour and/or capital taxes, while rising consumption taxes.[9] This shift in the tax system increases the competitiveness of domestic firms with respect to foreign ones, both in domestic and export markets. In practice, however,

there are empirical limits to this strategy. A race to the bottom on corporate tax rates also raises increasing challenges about the social fairness of globalisation – and hence its sustainability – as President Macron stressed in Davos… and as is even pointed out sometimes in debates about Ireland.

Recent research has put emphasis on the noticeable influence that fiscal policy can have on variations in imbalances, including in the US and Germany. In this respect, the recent US tax reform adopted by Congress is expected to significantly boost the US economy, which is already at full employment, leading in turn to increasing imports and a widening external deficit. So, it clearly risks increasing global imbalances.[10] Symmetrically, within the euro area, some countries with large positive current accounts recently experienced budget surpluses (e.g. in 2017, 0.9% of GDP in Germany and 0.7% of GDP in the Netherlands). This suggests that a fiscal boost in those countries could help to correct intra-euro area imbalances, be it through public investment spending or tax cuts for households.

So, what is the solution? More than ever, there is a need today for active multilateralism to face our global challenges. In the uncertain world of 2018, it is the responsibility of a strong Europe, along with Canada and some Asian partners, to convey this message.

Let me conclude by focusing on the intra-European level. The euro area is experiencing an excess of savings relative to investment of about 3.5% of GDP (12-month cumulated current account for the period ending in November 2017). **Savings should circulate more freely across Europe**, to where investment needs are, especially towards productive investment, and one notable way of achieving this is by shoring up equity which is the key to an innovation economy. A large part of the solution lies at the European level, with the building of what I call a **"Financing Union for Investment and Innovation"** (FUII), that would merge together the initiatives already in place – the "Capital Markets Union" (CMU) of course, but also the Banking Union and the Juncker Plan. In the Governing Council, we all find it regrettable that CMU is presently the forgotten child in the political discussions about the strengthening of the euro area. CMU would help significantly to foster private risk-sharing by:

- First, providing incentives for cross-border investments – preferably in equity – through the harmonisation of accounting, taxes and insolvency laws;
- Second, developing pan-European savings products more oriented towards long-term investment. This could be done through a variety of savings vehicles, starting with the creation of European venture capital funds;
- Third, completing the Banking Union.

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To conclude, global imbalances are not inevitable and we always need fresh ideas to improve the functioning of our globalised economies. In this respect, I would like to quote George Bernard Shaw, the famous Irish writer, who said once "You see things; and you say 'Why?'. But I dream things that never were; and I say 'Why not?'" Thank you for your attention.

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