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More stability by reducing economic imbalances

Economic imbalances are one of the major causes of the global financial and economic crisis. Primarily at issue are the large current account balances (see chart on page 3). It is not that these are a problem per se. And the severity of the crisis has caused them to contract somewhat. If the economy continues to recover, however, it is highly probable that they will increase again.

The capital imports associated with a current account deficit can be used to build up the economy's capital stock, for instance. Countries with a current account surplus, on the other hand, can accumulate assets abroad which can subsequently flow back into the domestic economy for purposes such as cushioning against demographic change.

Current account balances – what's the problem?

Flexible exchange rates normally help to reduce current account balances. The currency of a country in surplus increases in value – imports become cheaper and exports more expensive. This mitigates the tendency to build up a surplus. But several emerging and commodity-exporting countries have been bypassing this mechanism for some time. China, for example, keeps its exchange rate largely stable by buying US dollars on the currency markets. This exchange rate intervention has the side effect of generating additional liquidity, which acts on the world economy like a cut in interest rates.

A brief word



Analyses of the causes of the financial and economic crisis are not in short supply. Quite rightly, these have focused first and foremost on the financial sector. Major lessons to be learned from the crisis therefore concern the regulation and supervision of banks and financial markets.

But the causes are many and varied. The severity of the crisis can only be explained by the combined effects of a number of factors. These include not only undesirable developments in the financial sector and property markets, but also the macroeconomic climate. Large current account imbalances were a key feature of the global economy in the run-up to the crisis.

Imbalances of this kind are unsustainable in the long term, however, and pose a threat of a disorderly correction. What is more, they have the potential to seriously distort capital flows. It is therefore greatly to be welcomed that the G20 decided in September 2009 to address the whole issue of macroeconomic imbalances. A framework for strong, sustainable and balanced growth is to be established. Precisely what this will entail in practice remains to be seen. But the plan most certainly deserves support.

A handwritten signature in black ink, appearing to read 'Manfred Weber', written in a cursive style.

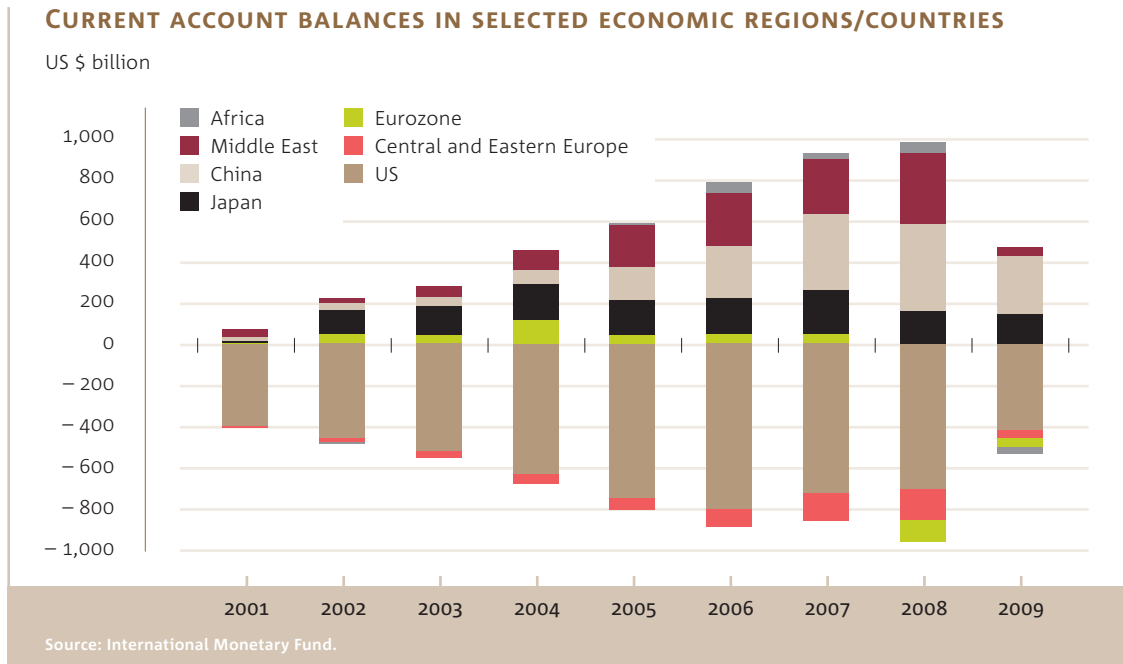
Manfred Weber
Chief Executive

In addition to this side effect, however, two major problems arise:

- Current account deficits are mainly regarded as unsustainable in the long term because the capital imports needed to finance them lead to a rise in the foreign debt of the country with the deficit (see box on page 4). Should there be any doubts about the ability to repay this debt – because, perhaps, the imported capital turns out to have been put to less profitable use than anticipated – there may be a run on the country's currency, resulting in a “disorderly” adjustment and financial market turmoil.
- Large and long-term current account balances can distort capital flows, especially if they are accompanied by extensive intervention in the currency markets, i.e. politically manipulated exchange rates. Possible consequences are asset price bubbles and the misallocation of savings.

China, in particular, has kept its exchange rate against the US currency comparatively low by continuously buying up dollars. Especially in the run-up to the crisis, it invested the bulk of the resulting currency reserves in US government bonds. The strong demand for these bonds meant that long-term real interest rates in the US were very low even in the period from mid-2004 to mid-2006 when the Fed was raising its interest rates.

This made it easy for US households to accumulate even more debt, and the current account deficit grew further. Many investors responded to the low yields on US government bonds by turning to more profitable, but also riskier forms of investment, as a result of which the price of risk fell. In short: a combination of extremely low interest rates, abundant liquidity and a rapid expansion of lending encouraged excesses in some asset markets, finally leading to the bursting of the US property bubble.



Guidelines are needed

In future, greater transparency and better regulation are to minimise undesirable developments in the capital markets. Various approaches are currently under discussion. But these need to be complemented and supported by measures to reduce unsustainable current account balances and the associated risk of capital flow imbalances and disorderly adjustments.

The following economic policy guidelines would be helpful in this respect:

- If a country has a large current account surplus and a fixed exchange rate, it should move towards greater exchange rate flexibility. Currency intervention should not be used to strengthen current account balances, or at least not for a prolonged period. This is also in the interests of the country running the surplus, not least owing to the growing danger of a loss in the value of its foreign assets.
- Countries with a high current account deficit and rising foreign debt should use capital inflows primarily for investment rather than consumption. It would not be desirable in such a

situation for the household savings ratio to fall. If the investment sparks stronger economic growth, the current account deficit will tend to shrink and, above all, it will be easier for the country to service its debt.

- Countries with a large current account deficit should also avoid stimulating domestic demand further by simultaneously running a budget deficit. They should focus instead on taking rigorous steps to consolidate the budget.

The G20 is currently discussing a framework for “strong, sustainable and balanced growth”. Initial recommendations are to be unveiled at the G20’s June summit in Toronto. It would be highly desirable for these to include the above guidelines. Nevertheless, it should be borne in mind that economic policy coordination is difficult enough within the EU, let alone worldwide. Realism is therefore called for.

The situation in Germany – specific effects stemming from the single currency

There has also been criticism of Germany’s large current account surplus in discussions about macroeconomic imbalances. Important aspects

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of the situation are often overlooked, however. Unlike in many emerging and commodity-exporting countries, the current account surplus in Germany has not been built up primarily by currency intervention, i.e. an exchange rate held artificially low for political reasons, but is the result above all of the competitiveness of German companies.

What is more, much of Germany's export surplus is due to trade within the European currency union. The eurozone as a whole has run a more or less balanced current account with the rest of the world in recent years. The imbalances within the eurozone, by contrast, demonstrate the fun-

Current account balances and capital flows

- A current account deficit means that domestic demand (consumption and investment) is greater than domestic production. This outstanding demand has to be financed by capital inflows from abroad. A prolonged, large-scale deficit will therefore be accompanied by an increase in the country's foreign debt. The adverse effect on financial solvency is a major risk associated with current account deficits.
- Conversely, current account surpluses entail an export of capital. Net foreign assets increase in a country running a current account surplus. This tends to put upward pressure on its currency. If the value of the domestic currency rises, however, the value of the country's net foreign assets and foreign currency reserves will fall correspondingly. Part of the export surplus will be "gifted" to other countries, so to speak.

damental difficulties faced by a currency union or fixed exchange rate system when the price competitiveness of participating countries develops differently for too long. One thing is clear: if the overall competitiveness of the euro area is not to deteriorate, the less competitive member states must catch up. The solution cannot be to tie a "dead weight" to the German economy.

It would nevertheless be in the interests of economic stability for Germany to reduce its dependence on exports and boost domestic demand. There is no easy recipe for this process. Excessive wage increases would result first and foremost in a sharp rise in unemployment and tend to depress rather than encourage household spending. Credit-funded tax cuts, on the other hand, would exacerbate already critically high levels of government debt.

A more promising approach would be to eliminate overregulation and barriers to market access in the services sector – among the professions, for example –, further reduce unemployment and establish a better climate for investment. This will involve above all improvements in education and in research and development. In summary, therefore, a package of measures along the lines of those recommended by the OECD in its recent report on Germany.