



Global imbalances and prospects for the world economy

By Dr Steven Dunaway
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Authorship

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Introduction

Most explanations of the current economic and financial crisis focus on its financial causes. Often missing in these explanations is a discussion of how the seeds of the crisis were sown by economic policies in major countries that fostered the growth of global imbalances during the 2000s. Moreover, just as these imbalances created the current crisis, exactly how they are likely to unwind—or fail to be resolved—over the period immediately ahead will play a major role in determining the prospects for world economic recovery and the pace of future growth.

Largely reflecting economic policies, substantial imbalances in savings and investment emerged among major world economies after 2000, and these imbalances were reflected in growing current account imbalances. Rising U.S. deficits and increasing surpluses in emerging East Asian economies (especially China) and oil-exporting countries in the Middle East developed. The underlying savings and investment imbalances gave rise to a “savings glut” in developing countries and spawned sizable net capital flows to the advanced countries, with the United States being the primary recipient. This glut of savings contributed to a substantial reduction in world interest rates.¹ At the same time, a significant rise in demand for official reserve assets (largely in the form of U.S. Treasury and Agency securities), especially by East Asian and Middle Eastern economies, crowded out private demand for such high-quality, low-risk assets. Consequently, a scramble by private investors to try to find other higher yielding but low-risk assets contributed to the financial excesses that finally culminated in the turmoil that gripped world financial markets in late 2008 and early 2009.

Since the onset of the crisis, current account imbalances among the major economies have declined. But to a large extent this development reflects the effects of the economic downturn. Economic policy changes are needed to address the underlying imbalances in savings and investment behavior that continue to exist. The policy actions needed are well known and have been widely discussed for a number of years now.² Discussion of such measures currently and consideration of implementing them generally have been put on hold. Instead, policies have been focused on dealing with the economic downturn and the regulatory failures that played a

1 Ben S. Bernanke, “The Global Savings Glut and the U.S. Current Account Deficit,” Homer Jones Lecture, April 14, 2005, and “Global Imbalances: Recent Developments and Prospects,” Bundesbank Lecture, September 11, 2007.

2 The International Monetary Fund has written at length about the problem of global imbalances since the early 2000s. See World Economic Outlook, International Monetary Fund, various issues.

major role in the financial aspects of the current crisis. However, active consideration of these measures needs to be revived. A critical challenge for policymakers in formulating policies that both cushion the economic downturn and promote economic recovery, is also to look to adopting policies that will address global imbalances at a reasonable pace. These are not conflicting objectives and only by doing so will it be possible to achieve more robust and stable growth in the world's major economies over the medium term.

At this juncture, the situation overall is not encouraging. While some policies being pursued will facilitate the adjustment of global imbalances, actions in many countries appear likely to add to imbalances over time, and the lack of needed policy actions—especially structural reforms—in other countries will delay adjustment as well. Consequently, the outlook for recovery and growth in the world economy does not look good. With adjustment in imbalances occurring in the United States that will result in significantly slower growth in demand, the key challenge for the world economy will be to find other sources of demand to take the place of the U.S. However, this appears likely to be a daunting task. None of the other major economies appear inclined to make the necessary changes in policies to deal with their imbalances and raise their demand. In these circumstances, the world is likely to face a prolonged period of slower growth and greater instability than it has known for several decades.

For a small, open economy like New Zealand, this situation will pose a very inhospitable environment. While there is little that New Zealand can do to change things, the key to making the best of a bad situation will be to retain the economy's flexibility and adaptability.

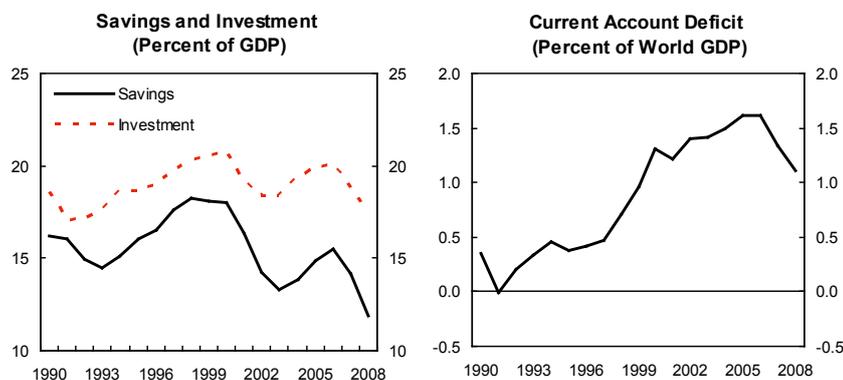
The Rise of Global Imbalances

Economic policies in major countries were the primary factor behind the rise of global imbalances during the 2000s. Policy-induced distortions gave rise to substantial imbalances in savings and investment that were reflected in large current account imbalances. However, the current account imbalances themselves were not per se evidence of global imbalances. It was the effects of policies that drove the savings and investment patterns that created the problem of global imbalances. The large current account deficits and surpluses that emerged just reflected the underlying economic situation.

It was differences in the underlying economic situation that marked the very sharp contrast between the current account imbalances of the 1990s and those of the 2000s, especially in the case of the United States. The rise in the U.S. current account deficit during the 1990s was not indicative of major policy misalignments (Figure 1).

U.S. national saving actually rose, as policy actions led to consolidation of the fiscal position. Investment, reflecting the boom prompted by rising productivity in the wake of the information technology changes, rose sharply relative to the increase in savings, and it was the rise in investment that drove the increase in the U.S. current account deficit. Inflows of capital funded the investment boom in the United States and led to a sharp appreciation of the U.S. dollar, which served to push up the current account deficit.

Figure 1. United States: Savings, Investment, and Current Account Deficit



Source: Treasury (2008a) Source: International Monetary Fund, World Economic Outlook 2009

Imbalances Among the Major Economies in the 2000s

The U.S. current account deficit rose further during the 2000s. Business fixed investment slowed over much of this period and did not return to its levels relative to GDP achieved in the second half of the 1990s. But this decline was more than offset by a drop in national savings relative to GDP. This drop reflected in part a dramatic shift to an expansionary fiscal policy. It also reflected a decline in household savings, as low interest rates and increased availability of financing related to housing sparked a boom in consumption. Moreover, in sharp contrast to the 1990s, the value of the U.S. dollar declined after 2001, at times facing strong downward pressure.

Consumption-fueled growth in the United States fostered economic expansions in Japan and Europe on the back of higher exports. Corporate savings rose as profits increased. However, problems in the structures of these countries' economies—especially rigidities in product and labor markets—limited opportunities for domestic investment. Private consumption growth remained sluggish, reflecting uncertainties about employment prospects and slow wage growth. The combination of high savings and sluggish investment led to rising national savings and external surpluses (Figures 2 and 3).

Figure 2. Euro Area: Savings, Investment, and Current Account Balance

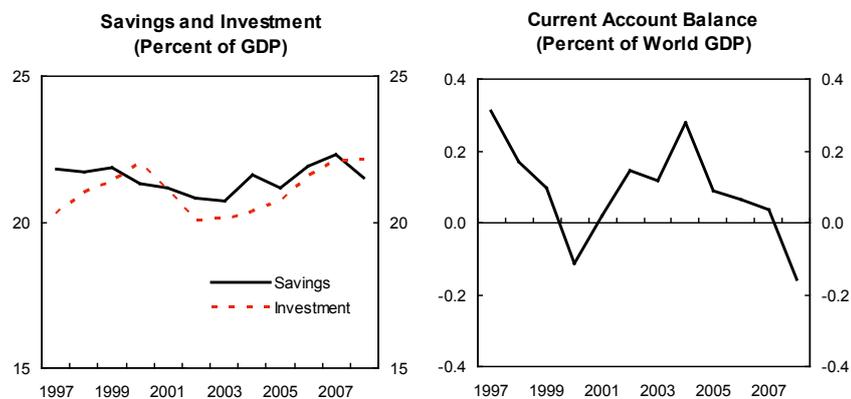
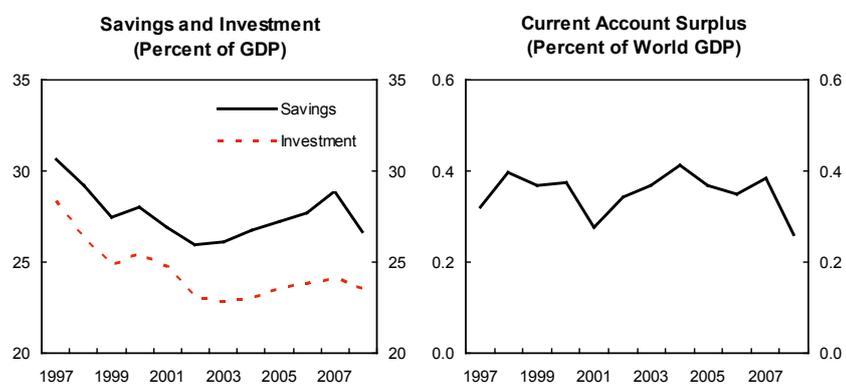


Figure 3. Japan: Savings, Investment, and Current Account Surplus



Source: Treasury (2008a) Source: International Monetary Fund, World Economic Outlook 2009.

Savings and investment imbalances and current account surpluses of developing countries also rose sharply. In particular, the years after 2000 witnessed a dramatic rise in the savings and investment imbalance in China. Despite very strong investment, Chinese savings posted an even larger rise. The fiscal position (government savings) improved significantly, but it was the rise in corporate savings that explained most of the increase in China's national savings (Figure 4).

In emerging economies in East Asia other than China³, investment relative to GDP declined in the years after the Asian financial crisis of 1997-98 (Figure 5). Investment in structures fell sharply following the excesses that occurred in the buildup to the Asian financial crisis. External surpluses also reflected policy decisions in many of these countries to rebuild official reserves, which had been decimated during the crisis. These surpluses also reflected concerns regarding competitive pressures on these countries posed by China. Accordingly these countries engaged in substantial sterilized intervention. However, concerns about rising inflationary pressures after 2006 led many of them to increase the flexibility of their exchange rates.

After 2002, current account surpluses of Middle East oil-exporting countries began to rise substantially (Figure 6). Initially, concerns about the security of oil supplies drove up prices, in the wake of the war in Iraq. But price pressures also increased as global demand for oil rose sharply with a significant rise in demand from countries in East Asia and India.

The substantial savings by East Asian emerging economies and Middle East oil-exporting countries gave rise to large net capital outflows. Most of these flows found their way to the United States. With the desired level of savings in the world exceeding desired investment at the interest rates prevailing at the time, the glut of global savings drove down real rates of interest and contributed to a boom in asset prices.

Over time, the cycle began to feed on itself. With expanded availability of credit and lower interest rates, U.S. households used debt to fuel a housing boom, and they used rising housing wealth to finance sustained growth in consumption. In turn, rising U.S. demand stimulated additional growth in the rest of the world, adding to current account surpluses, especially in East Asian emerging-market economies. Among these countries, China's current account surplus skyrocketed and official reserves rose to record levels. Competitive pressures from China also created pressure on other East Asian countries to limit the appreciation of their currencies against the U.S. dollar. The current account surpluses of oil-exporting countries in the Middle East also rose. As the developing countries' external surpluses were funneled back to the United States through net capital flows, this financing helped fund a continuation of the consumption and housing boom and a steady rise in asset prices and ultimately led to the financial crisis that began in August 2008.

Blame for the financial excesses that occurred and the ensuing crisis is often attributed to the U.S. Federal Reserve (the Fed). It is asserted that the Fed permitted loose monetary conditions to prevail for too long. Financial

³ This group includes Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand, and Vietnam. Korea is included in the group for convenience, although it is now classified as an advanced economy.

Figure 4. China: Savings, Investment, and Current Account Surplus

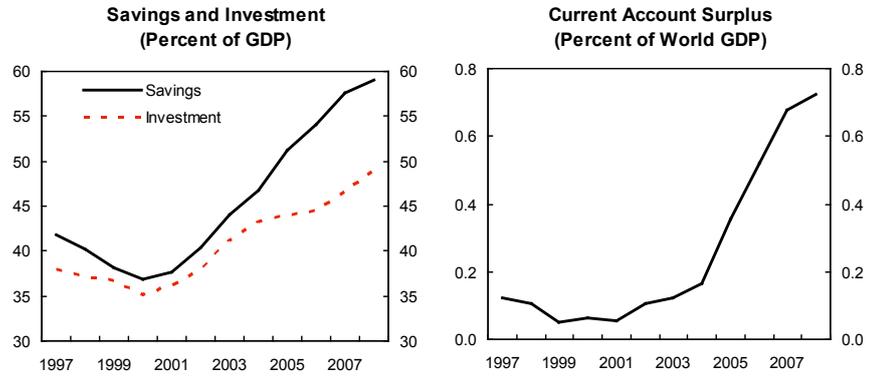


Figure 5. Emerging East Asia: Savings, Investment, and Current Account Surplus

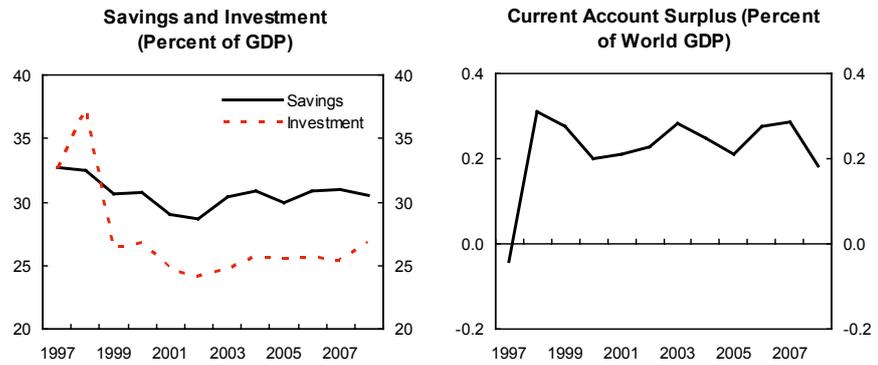
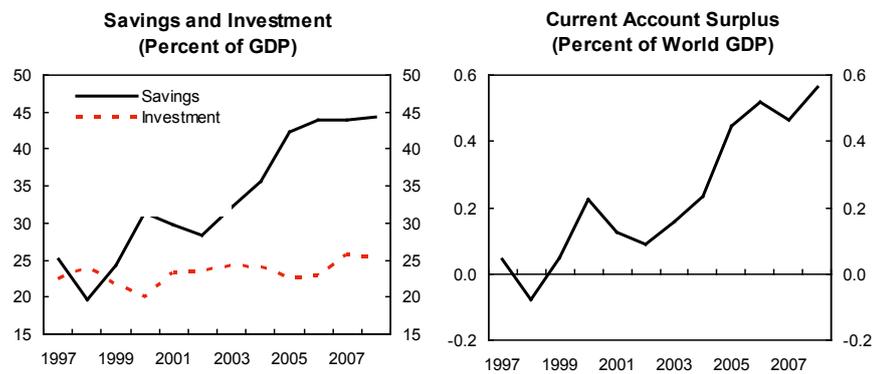


Figure 6. Middle East: Savings, Investment, and Current Account Surplus



Source: International Monetary Fund, World Economic Outlook 2009

difficulties could have been reduced or precluded if the Fed had tightened policy earlier. This argument in effect suggests that the Fed alone should have tried to offset the impact of global imbalances. It fails to recognize the difficulty of such a task. With the inflows of capital to the United States arising from the imbalances, the yield curve in the United States was relatively flat through much of the 2000s, suggesting that a decision by the Fed to hike short-term policy rates might not have fully passed through into long-term rates. Indeed, senior Fed officials had commented on the unusual difficulties being encountered in trying to use monetary policy to influence long-term interest rates. Former chairman Alan Greenspan often spoke of an "interest rate conundrum,"⁴ and then deputy chairman Ben Bernanke offered the "savings glut" as an explanation for the low level of long-term interest rates.

The flat yield curve did not indicate that the Fed could not bring about an increase in long-term interest rates. Monetary policy could have been tightened, but a substantial policy tightening would have been required. Such aggressive use of monetary policy would have inflicted a very high cost on the U.S. economy and in turn the rest of the world. While the costs inflicted by the current economic and financial crisis are quite high, the relevant question is whether other policy alternatives would have been better placed than monetary policy in order to deal with the situation at a much lower cost. Obviously, dealing more aggressively with global imbalances would have been the most appropriate policy response.

Failures in regulation and supervision played a particularly important part in feeding the excesses that developed in the markets for asset-backed securities that eventually triggered the financial turmoil after August 2008. There were indications that problems were emerging, but regulatory authorities did not take significant actions. In part, this reflected the fragmented regulatory system in the United States where a number of different entities each have responsibility for specific segments of the financial market.⁵ Laxness in regulation also played a role. Such laxness was partly by design reflecting the political philosophy of the U.S. Administration and a desire to encourage innovation in the financial markets. As well, it may have reflected difficulties on the part of the regulators in keeping up with the financial market innovations taking place. However, a major factor appears to have been a failure on the part of banking regulators to fully comprehend the risks that the banking system was taking on. In the end, even if the regulatory and supervisory problem could have been avoided, this would only have dampened the magnitude of the crisis, but it could not have prevented it.

Features of the International Financial System Facilitated Global Imbalances

Normally, a current account imbalance would be expected to trigger forces that would promote adjustment and maintain the imbalance at a

4 See "Testimony of Chairman Alan Greenspan," The Federal Reserve Board's Semiannual Monetary Policy Report to the Congress, delivered before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 16, 2005.

5 In Europe, fragmentation of regulatory authority may also have played a role. Within the euro area, each country continues to maintain its own regulatory regime, and these regimes vary widely.

sustainable level. Countries with deficits usually face increasing difficulties in obtaining financing. Adjustment then takes place through upward pressure on domestic interest rates, downward pressure on the real exchange rate, and slowing domestic economic activity. Surplus countries face pressures in the opposite direction, with rising economic activity and appreciation of the real exchange rate being the main forces that prompt balance-of-payments adjustment. That global imbalances were able to grow and persist for an extended period of time points to features in the international financial system that have worked to delay adjustment.

One such feature is the role played by countries that provide official reserve assets. This is an important feature that gives needed scope for reserve assets in the system to expand as the world economy and international trade grow. But it can also enable a country that provides reserve assets to delay adjustment in its external position because the country can finance a deficit rather easily for some time by issuing assets in its domestic currency.

To a significant extent, flows of capital to the United States reflected a strong preference for U.S. dollar assets owing to the pivotal role the dollar plays as a reserve currency. Consequently, the United States was able to finance its external deficits and delay needed adjustments in domestic savings. But the dollar's role as the principal reserve currency was not the sole reason for the ease in financing its external deficit that the United States experienced during the 2000s. There were also sizable net flows of private capital into the United States because of a perception that U.S. markets were better regulated, had better governance, and were more secure than markets in emerging economies. Moreover, in the first part of the 2000s, economic growth was faster in the United States and returns on financial assets were perceived as being higher than in other advanced countries. As a result, a self-reinforcing effect set in. As capital inflows to the United States boosted asset prices and returns, additional flows of capital were stimulated.

A second feature of the international system that contributed to the growth in imbalances is that countries with balance of payments surpluses that manage their exchange rates can resist upward pressure on their currencies for extended periods. Deficit countries facing downward pressure on their exchange rates can defend the rate and finance their deficits only as long as they have official reserves or are willing to use their reserve assets.⁶ But countries facing upward pressure on their rates have no such reserve constraint, given that the rest of the world is demanding their currencies. They can hold their exchange rates by intervening in the market and selling their own currencies. To offset effects on domestic monetary conditions and forestall a rise in inflation that would induce a real appreciation of their currencies, these countries can attempt to "sterilize" their exchange market interventions through domestic monetary policy actions.

There are limits, however, to how long sterilized intervention will work. In particular, the cost of such intervention in terms of higher domestic interest rates will eventually take its toll on the finances of the central bank and have consequences for the real economy, but these adverse

⁶ Using foreign exchange controls can extend the period, but the resulting impact on the real economy can be rather harsh and such actions directed at current account transactions can invite retaliation by other countries.

effects may go unnoticed for quite some time. To diminish some of these serious consequences, sterilized intervention can be supported by capital controls and administrative controls over domestic financial markets (e.g., moral suasion or window guidance to control credit growth).⁷ Although the effectiveness of capital and administrative controls will diminish over time, such measures can succeed for a while.⁸

Imposing capital and administrative controls is not without cost because of the distortions they create and the repression of the financial system that tends to occur. Moreover, like any price distortion, maintaining an undervalued exchange rate will impose large costs on the real economy. The distortion in the value of the exchange rate will create serious misallocations of resources in the export- and import-substituting sectors of the economy. The longer an undervaluation of the currency is maintained, the greater the misallocations created and the more difficult the readjustment the economy must undergo to unwind these misallocations.

Among the emerging economies in East Asia, China is the one that most exploited this flaw in the international financial system during the 2000s. To maintain an increasingly undervalued exchange rate, China had to amass a stunning amount of official reserves; with nearly \$1.6 trillion of these reserves (roughly $\frac{3}{4}$ of China's total reserve holdings) being accumulated in the period after the country's exchange rate regime was changed in July 2005.

Another feature of the international financial system that worked to encourage delay in external adjustment arises as an inadvertent consequence of floating exchange rates. A depreciating currency can provide a "sheltering effect" for the traded goods sector of a country's economy, and thus slow adjustment to adverse economic shocks arising from structural changes.⁹ Specifically, currency depreciation can reduce pressure on a country's external position, providing an opportunity to more gradually make policy changes—especially reforms in the structure of a country's economy—that may be needed to deal with the consequences of a shock. Because currency depreciation initially has a positive effect on economic growth, the tendency is to overlook the longer-term negative consequences. Moreover, slower initial adjustment can also contribute to depreciation pressures on a country's exchange rate that can persist for some time, providing additional incentive for adjustment delay.

Liberalization of trade during the 1990s and the rise of the newly industrializing countries, particularly China, was a major competitive shock to advanced economies. This shock had particularly strong effects on European economies, with their rigid product and labor markets. Japan was also affected for similar reasons. Depreciation in their currencies during the late 1990s took some of the pressure off both Europe and

7 The so-called iron trinity argument suggests that by instituting capital controls, a country trying to peg its exchange rate is able to pursue an independent monetary policy.

8 Capital controls can be looked at as being equivalent to a tax on international capital movements. When potential returns are high enough, investors will be willing to incur additional costs to evade the controls, and the higher the potential return, the greater the incentive for investors to evade.

9 See, for example, Richard G. Harris, *The New Economy and the Exchange Rate Regime*, Center for International Economic Studies, Adelaide University, March 2001.

Japan to implement structural reforms. In Europe, labor market reforms were badly needed but politically difficult to implement. Some reforms were enacted, but these reforms were partial and incomplete. Moreover, by delaying reform, European countries set themselves up for a sharp slowdown in growth when the euro began to appreciate in the 2000s. The impact of that appreciation was initially blunted by strong demand from the Middle East and China that boosted exports of the major European economies, principally Germany and France, but this demand evaporated during the current economic and financial crisis.

Other Reasons for Delayed Adjustment

Adjustment in policies was also delayed by an emerging belief that the problem of global imbalances would diminish over time as growth outside of the United States—particularly in Europe and East Asia—was seen to be decoupling from U.S. growth. In addition, it was argued that other countries—especially China—were stepping up to become engines to sustain world growth. The problem of global imbalances was increasingly thought to be potentially self-correcting. Accordingly, it was believed that there was time for more gradual changes in economic policies in the major countries.¹⁰

The decoupling and new engines of growth myths stemmed from a simplistic analysis of national accounts data. The data for Europe and East Asian countries indicated that domestic demand, not net exports, was increasingly the major contributor to economic growth, hence the view that growth in these economies had decoupled from growth elsewhere. The new engines myth was derived from an analysis of world GDP data, which showed that other countries' contributions to world GDP growth were rising relative to the contribution of the United States. Indeed, China's contribution to world growth exceeded that of the United States in 2007.

The basic problem with the analysis underlying the decoupling myth was that it focused solely on the proximate sources of growth. No attempt was made to try to determine whether domestic demand growth was self-sustaining or whether it was generated as the knock-on (or multiplier) effect arising from the income derived from exports. Similarly, in the new engines of growth myth, the suggestion that China was becoming a growth engine for the world economy did not factor in whether China was actually generating demand for the rest of the world. China certainly was, to some extent, doing so for the rest of Asia. However, the engine

¹⁰ In the report on the multilateral consultation with major members held by the IMF in late 2006 and early 2007, the view of the participating countries was: "The [global] imbalances were seen as a fundamentally medium-term problem that required medium-term solutions. There was general agreement that a correction in global imbalances would eventually be necessary, but with the U.S. current account deficit still being relatively easily financed, most saw the immediate risks as low; the greatest concern was that imbalances could add to protectionist pressures, on both the current and capital account. Thus the policy strategy should be gradualist in nature, consistent with and supportive of the necessary adjustment in the private sector, and aiming to build confidence that a credible and consistent strategy to reduce imbalances was being pursued." "Staff Report on the Multilateral Consultation on Global Imbalances with China, the Euro Area, Japan, Saudi Arabia, and the United States," International Monetary Fund, June 2007.

ultimately driving China's import demand was China's exports.¹¹

That the recession in the United States has had a more severe than expected impact on the rest of the world has exposed these propositions as myths and dashed hopes that a permanent correction in global imbalances could be achieved without a severe disruption to world growth. The financial turmoil may have added to the slowdown in the rest of the world, but it is the loss of stimulus derived from U.S. demand that has been the major factor in slowing economic growth worldwide. Now there is a clear need for policy actions to deal with the problem, and global imbalances should no longer be considered a medium-term problem that can be dealt with gradually.

Prospects for the World Economy

Understandably, the policy focus up until now has been on tackling the immediate problems of dealing with major financial disruptions, stabilizing the world's major economies, and trying to restart growth. Any thinking beyond these initial challenges has been directed at addressing financial sector regulatory and supervisory failures. Increasingly, light is being seen at the end of the tunnel, and the beginnings of economic recovery are being proclaimed. Exit strategies from economic stimulus measures are being discussed. But, although it is recognized that economic growth going forward may be relatively slow, little attention is being given to finally coming to grips with the fundamental problems in the real economies of the major countries that gave rise to global imbalances and sowed the seeds for the crisis. Resolving these problems are key to achieving a robust, sustained expansion of growth in the major economies. The world economy emerging from the current crisis will be very different from the one that existed before. The major difference is that some adjustment in global imbalances is likely to take place; however, this adjustment will be uneven and the unevenness will tend to slow world growth. In particular, imbalances in the United States will adjust and U.S. growth will slow. But it is not clear which of the other major economies will step up to pick up the slack in demand.

Adjustment in the United States

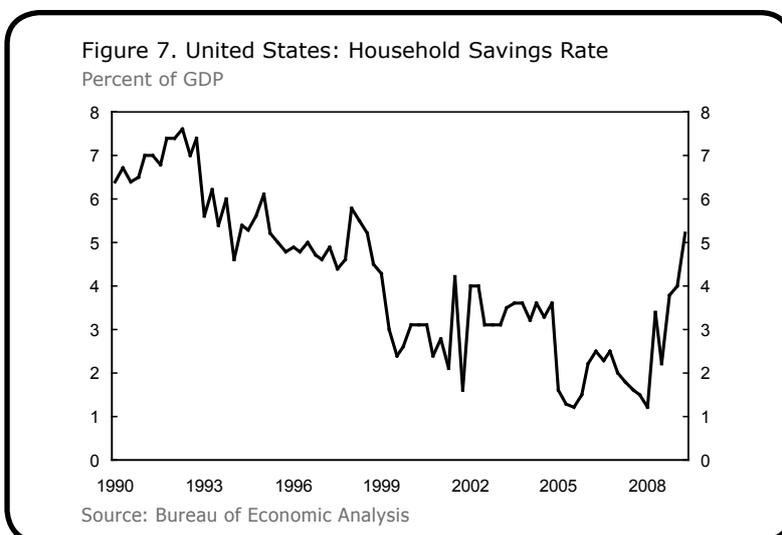
At this point, only in the United States does it appear that adjustment in global imbalances is taking place. In particular, savings in the household sector have risen significantly, and these increases are likely to be permanent. The decline in housing prices has had a major impact on savings behavior. The surge in consumption during the economic expansion in the early 2000s was heavily linked to increases in the value of housing. However, this consumption boom did not reflect a traditional wealth effect; it was predominantly a financing phenomenon. Innovations in financial markets increased access to credit for households by making it very easy for individuals to tap the equity in their homes to fund consumption expenditures. But this source of financing for consumption has dried up.

¹¹ In fact, the slowing in China's export growth in late 2008 and 2009 has been accompanied by a substantial slowdown in the growth of China's imports.

With lower house prices, households have less equity in their homes and with a greater debt burden acquired in the previous expansion, households are more reluctant to borrow. Consequently, savings (Figure 7) is rising, and in recent quarters, it has returned to its previous trend value. During the last economic expansion in the 1990s, household savings averaged about 5-6 percent of disposable personal income, compared with the near zero rate recorder during the final years of the economic expansion in the 2000s.

There are reasons to believe that the U.S. household savings rate will rise significantly above its current level. Households have experienced a substantial decline in financial wealth, as well as a sharp fall in the value of housing. Savings will have to rise as individuals seek to rebuild their wealth. This is particularly the case for members of the baby boom generation because they are fast approaching the traditional age for retirement. They now have no choice but to significantly raise their savings or postpone retirement. In the early 1990s, the baby boomers faced a somewhat similar need to increase financial resources for retirement. At that time, they had two basic choices: to save more or to raise the returns on their existing savings. They chose to raise returns on their assets by shifting their portfolios toward higher yielding equity investments. Households have already diversified their portfolios heavily into equities, and they have little room to shift them further and little appetite to do so. Twice in the past decade major stock market corrections have hit household financial wealth hard, making equity investments look a lot more risky than they were perceived to be originally. In these circumstances, the baby boomers are likely to choose to raise their savings significantly.

The U.S. government will also have to increase its savings to deal with the massive fiscal deficit that has opened up, in part owing to the necessary measures that the current Administration has taken to stabilize the economy. But government savings will also have to rise to deal with the underlying imbalance in the U.S. fiscal position that has existed since the previous Administration embarked on a substantial fiscal expansion in the early 2000s. In order for the U.S. government to be able to meet its obligations to its aging population without having to resort to major increases in taxes or cuts in spending (including programs for the elderly),



the budget will have to be brought back into surplus and that surplus will have to be maintained for some time to cope with the pressures associated with the aging of the population over the medium term.

The Administration has recognized the need for fiscal consolidation. Its budget blueprint released in early 2009 lays out a credible plan for beginning this process. However, in implementing a substantial fiscal consolidation on the scale of what is needed, the Administration will face some tough choices, especially in an economic and political environment that may not appear readily conducive to fiscal consolidation. Relatively slow economic growth over the next several years will offer a convenient pretext for putting off adjustment. But the Administration will have to proceed anyway or risk creating conditions that will result in persistent slow growth.

Somewhat slower growth in the near term arising from moving ahead with fiscal consolidation is a necessary tradeoff to achieve sustainable budget finances over the medium term. Delaying fiscal adjustment would provide only a marginally higher rate of growth for a short period of time at the expense of a more protracted period of slow growth. Near term growth would tend to be only marginally higher because household savings are likely to rise even further as households recognize that either medium-term government promises regarding pension and health care benefits would be broken or that taxes would have to be substantially higher or other government spending cut. A protracted period of large fiscal deficits would also significantly push up real interest rates and reduce investment, reducing growth. So in the end, the Administration has only one responsible choice and that is to proceed with fiscal consolidation as economic recovery takes hold in the next one to two years.

Therefore, it can be expected that national savings in the United States will rise substantially in the period ahead. Thus, adjustment in the U.S. savings and investment imbalance will take place and the current account deficit will narrow. Consequently, demand in the United States over the next decade or so will grow substantially slower than it has in the preceding three decades.

Picking Up the Slack: Europe and Japan?

Europe is an unlikely candidate to pick up the slack in world demand resulting from slower U.S. growth. Major European countries—particularly Germany—look likely to remain heavily dependent on exports to drive their economies. This situation reflects in part a sense of complacency among the Europeans and a lack of political will, especially in current circumstances, to make some difficult policy choices. The complacency of the Europeans arises from their view that they are victims in the current economic and financial crisis. They see little wrong in the economic policies that they have followed. In particular, they argue that they have developed a competitive advantage in the export of certain types of goods, and exploiting this advantage was a major impetus to growth in the period before the current crisis. They see no reason to change this basic model for growth.

Weak political will increases the Europeans' reluctance to take policy

actions to improve their medium-term economic performance, especially because such actions are seen as entailing significant near-term costs. No serious consideration is being given to diversifying their economies by removing barriers that constrain Europe's growth. There is no appetite for dealing with the significant rigidities that exist in labor and product markets. Instead, the Europeans are content to wait for world growth to resume. They tend to believe that the world economy will essentially go back relatively quickly to levels of activity and demand similar to those that prevailed before the current crisis.

However, things will not be the same. In addition to slow demand growth in the United States, growth in demand within Europe will be significantly slower than previously. Growth in Eastern Europe will be less robust as these countries cope with the fallout from the current crisis. These countries will have to deal with an overhang of foreign currency denominated debt, and they will encounter difficulties in rolling over existing loans and a drying up of new credit flows, especially as Western European lenders scale back their operations. Moreover, these countries have generally experienced a significant loss in competitiveness. The only way for them to restore competitiveness, if they seek to maintain fixed exchange rates or limit exchange rate movements relative to the euro, is through slower growth in their domestic demand.

But the biggest problem for Europe is within the euro area. The area's southern countries (Portugal, Italy, Greece, and Spain) have become non-competitive both within the euro area and externally. Since they are now members of the euro, they cannot rely—as they have in the past—on changes in their nominal exchange rates to produce a real depreciation in order to restore their competitiveness. They have only two choices. They can raise competitiveness by improving the efficiency of their economies through structural reforms. Or slow economic growth in these countries to allow an improvement in competitiveness through lower inflation than in the rest of the euro area. The latter is the likely way that competitiveness will be improved because of a lack of political will to implement needed reforms in these countries' product and labor markets. As a result, the countries of Southern Europe are in for a long and economically painful adjustment. This adjustment is likely to severely test the future of monetary union and the euro.

Slow growth in Southern and Eastern Europe will significantly impair growth in the Northern European countries. This will be especially true for Germany, which is very heavily dependent on exports to other European countries, as well as the rest of the world. Stagnation in Europe, coupled with slow U.S. growth, will directly depress growth in the rest of the world. But it may also have important indirect adverse effects on world growth. With slow growth throughout Europe and increased difficulties and stress in Southern Europe, protectionist pressures are likely to rise. The recent EU decision to impose anti-dumping duties on steel pipe imports from China on the basis of prospective (not actual) injury to the domestic industry from such imports may be a harbinger of further recourse to protection as recovery in Europe proceeds much more slowly than the Europeans currently expect.

Japan is expected to do little to pick up the slack in world demand. The

country appears to be on the verge of slipping into its second major deflation in the last two decades, and the country will remain dependent on exports for economic recovery and growth. At this juncture, the best the authorities are able to do is to try to limit the slide in the economy through monetary and fiscal policy actions. Scope for fiscal action is limited because of the massive size of the government's debt and the need to ensure adequate resources are available over the medium term to meet obligations to Japan's rapidly aging population. Consumption growth is likely to remain constrained as household savings remain high reflecting uncertainties about employment prospects and the government's ability to meet its pension and health care obligations without tax increases or spending cuts. Above all, Japan is mired in political instability that prevents it from taking meaningful steps to deal with structural problems in the economy,

The only hope for lifting Japan's potential growth rate and domestic demand over the medium term lies in implementing badly needed structural reforms—especially increasing the flexibility of product markets and improving access to the labor market. Enacting such measures would entail taking on entrenched vested interests and changing cultural norms. The fact that they will not significantly alter near-term economic prospects makes them politically very unattractive and unlikely to be implemented in the current political environment.

Myriad rules, regulations, and restrictions severely limit the scope for new entrants, innovation, and increased efficiency in many markets in Japan, particularly in distribution and the services sector. Moreover, the rapid aging of Japan's population adds to the urgency of opening up the labor market to avoid a further slowdown in Japan's already anaemic rate of growth. Increased immigration may play a part in providing needed labor resources, but a far more important role could be played by bringing back into the labor force an already well trained, disenfranchised group—namely Japanese women. The labor force participation rate of women in Japan is depressed by cultural factors, but more importantly it is constrained by the lack of adequate day care for children and elder care.

What About Asian Economies?

Asia is considered to be the bright spot in the world economy at the moment. On the whole, the emerging market economies of the region have been judged to have weathered the economic and financial crisis better than the advanced countries and better than expected late in 2008 and early 2009.¹² Growth in many of these countries is seen as picking up after sharp slumps. This has prompted some renewed discussion about decoupling of Asian economies from advanced country growth and suggestions that major countries in the region—particularly China—could be engines of growth for the world economy. Unfortunately, this prospect

¹² In large part, this better-than-expected performance reflects the overly pessimistic forecasts for these countries made in late 2008. China is a notable example. Most analysts forecasting China's growth for 2009 in late 2008 raced to mark down their forecast without giving adequate consideration to the effects of China's fiscal stimulus and credit loosening measures. As these same analysts now mark up their growth forecasts, there is a tendency to attribute the revisions to the Asian economies being more resilient to the crisis than to attribute them to forecast errors owing to underestimates of the effects of stimulus measures taken.

is highly unlikely.¹³ The perceived strength in economic activity in Asia at present looks to be associated with a temporary recovery in growth largely owing to a slowing of the rate of inventory decumulation or shifts to small inventory accumulation and to continued effects of fiscal and monetary stimulus measures. While Asia may be looking better than expected in 2009, economic prospects for the region in 2010 and beyond, in the absence of major changes in economic policies and structures, will remain heavily dependent on recovery and growth in the advanced countries.

China, in particular, appears to be weathering the crisis well, thanks to quick government policy actions to stimulate the economy. The authorities will achieve their 8 percent target for GDP growth in 2009. But relatively strong growth in China is not providing much stimulus for the rest of the world, as China's trade and current account surpluses remain large. Moreover, without a significant revival in external demand, it will be difficult for China to achieve its 8 percent GDP growth objective in 2010 and succeeding years unless the government continues to supply substantial stimulus to the economy to prop up growth, especially given the emphasis that continues to be placed on boosting investment.

China's economic development has been driven since the mid-1980s by investment growth. In the early years of economic reform in China (which began in 1978), consumption rose strongly and was the major factor in China's growth. As economic reforms in the urban areas began in earnest in the mid-1980s, there was a distinct shift in China's growth back toward the kind of investment-driven model that dominated China's development in the pre-reform era. This shift accelerated after the Tiananmen Square protests in 1989. A basic flaw in this development model became evident in the early 1990s as rapid investment growth led to increases in the production of goods that outstripped domestic demand. Mountains of "unsellable" goods built up as the government sought to maintain relatively rapid growth.

To resolve the problem, the Chinese authorities decided to find new external sources of demand for Chinese goods. They chose to stick to the investment-driven growth model and rely on exports and substitution of domestic production for imported goods to fully utilize the excess in productive capacity over domestic consumption that continued rapid investment would generate. Key reforms launched in the period 1994-95 opened up China's economy and served to shift production toward exports and import substitution. Also, set in place were key price distortions—especially a low cost of capital and an undervalued exchange rate—that supported this investment-driven/export-led growth model.

Policies that have maintained a low cost of capital in China have contributed to stunting the growth of consumption. Households over most of the past two decades have experienced a significant decline in personal income relative to GDP owing largely to a decline in investment income. Despite large savings, households' investment income has fallen relative to GDP because the major investment vehicle for these savings are bank deposits

¹³ This is a view shared by some leaders in the region. At the July 2009 U.S. and China Strategic and Economic Dialogue, China's central bank Governor, Zhou Xiaochuan, suggested that a sustainable recovery in China's growth would not occur until the U.S. economy recovered.

and a low ceiling has been set by the government for the interest rates paid on these deposits. In turn, a low deposit rate permits the banks to lend at relatively low rates. The cost of capital has also been held down by the virtual lack of dividend payments to the government by the state-owned enterprises.¹⁴ Consequently, retained earnings of these firms have been a large pool of low cost financing for investment.

The low cost of capital coupled with the poor intermediation of savings by the major state-owned commercial banks has resulted in substantial resources being directed toward the large state-owned enterprises, which tend to be in capital-intensive industries. As a result, production in China has become very capital intensive, creating the rather ironic situation that output growth does not generate much employment growth in a country that has such a large pool of underemployed workers. The official target for growth is set at 8 percent because that level of growth is viewed as being required to produce the 1-2 percent of employment growth needed per year to absorb new entrants to the work force and reduce somewhat the substantial underemployment of labor in the rural areas.¹⁵

At the same time, by maintaining an undervalued exchange rate China has imposed growing costs on its economy. In particular, it has created a serious overallocation of resources in export and import-substituting industries. This situation will have to be sorted out at some point, and the problem and the costs of sorting it out will only grow the longer adjustment is delayed. Moreover, when the inevitable appreciation in China's currency happens, the country will experience a substantial loss on the massive foreign exchange reserves it has accumulated while trying to keep its currency undervalued—a loss that the Chinese authorities are already very concerned about. Nevertheless, China's authorities are reluctant to allow the exchange rate to appreciate out of fear of the short-term impact appreciation could have on growth. As a consequence, costs of adjustment for the real economy increase and the country continues to pile up large amounts of reserves, making the capital loss that will eventually occur greater and greater.

Maintaining an undervalued exchange rate also stunts the development of China's financial sector. Efforts to get its banking system to operate on a sound commercial basis are undermined by the government's continued interference in the banks' business decisions through heavy reliance on window guidance to control credit expansion and establish lending priorities. The government has been forced to rely on such direct measures to influence bank lending out of concern that use of conventional indirect means of monetary control, which would rely on increases in domestic interest rates, could induce increasing inflows of foreign money as capital controls have become more porous.

China's growth model up to now certainly has delivered impressive results, making China the third largest economy in the world and closing in fast to being the number one trading nation. However, because of the country's success and its increased importance in the world economy, time appears to

¹⁴ Beginning in 2008, the central government's state-owned enterprises have been required on a trial basis to make modest dividend payments to the budget.

¹⁵ In contrast, advanced countries generate 1-2 percent of employment growth per year from 2-3 percent of GDP growth. See Jahangir Aziz and Steven Dunaway, "China's Rebalancing Act", Finance and Development, September 2007.

have run out on China's continued use of this investment-driven/export-led growth model. This is particularly true given prospects for slower demand in the advanced economies. Continued rapid investment in China will add to productive capacity and require continued strong export growth to take up the excess in productive capacity over what is demanded domestically. But to maintain relatively rapid export growth in a slowly growing world economy, China's producers will have to lower their export prices and cut their margins substantially to overcome competitive pressures so that they will be able to take the ever-increasing share of world trade required for China to be able to meet an 8 percent target for its growth.¹⁶ However, with declining margins, Chinese firms would be expected to cut investment over time if they are operating on a commercial basis. In these circumstances, Chinese banks too, if they are operating on a commercial basis, should be increasingly reluctant to lend. Consequently, rapid growth and development in China cannot be sustained unless there is strong continued fiscal support or increased government interference in business decisions. The situation facing China could be even worse if the country's attempts to maintain export growth were to invite increasing retaliation from partner countries.

Unfortunately, the past success of its growth model makes the Chinese authorities very reluctant to do more than make gradual changes to it. Policies adopted by the authorities to deal with the current economic and financial crisis generally continue to focus on boosting investment and stabilizing export growth.

In addition, the Chinese authorities are drawing the wrong lessons from the current crisis, leading the government to decide to play an even bigger role in the economy. Advanced countries' interventions in their financial systems are being taken as proof that China's system, which remains dominated by the government, is superior. The stability of China's banking system during the current financial crisis is only an indication of its detachment from world markets; it is not an indication of inherent strength or soundness. In reality, China's banking system is staggering forward toward its next crisis and recapitalization by the government. The system has been recapitalized twice in the last 10 years, and only limited progress has been achieved in reforming it and getting it to operate like an efficient, commercially based system. The government's push to have the banks expand lending as part of its economic stimulus plan probably brings forward the date when another recapitalization will be needed. Substantial new non-performing loans are expected to be created by the government-sanctioned surge in lending that has taken place. Advanced country interventions in the automobile industry are also seen as providing justification for China's efforts to restructure 14 of its major industries. As part of these restructurings, China's large state-owned enterprises are envisaged as playing a dominant role in these industries. This is likely to be a major step backward for the economy.

The Chinese authorities recognize the need for change, but they think that there is plenty of time to enact it. They have publicly stated that the economy needs to be rebalanced away from its heavy dependence on

¹⁶ Kai Guo and Papa N'Diaye, "Is China's Export-Oriented Growth Sustainable?", IMF Working Paper, No. 09/169, August 2009 provides a quantitative scenario illustrating this problem for China going forward.

investment and exports toward consumption.¹⁷ To do so requires removing price distortions and other policy changes to eliminate inefficiencies and incentives favoring investment over consumption. Serious distortions exist in the pricing of energy, other utilities, land, and pollution abatement; but, as noted above, the major price distortions are the low cost of capital and the undervalued exchange rate. Capital costs need to be raised significantly, and that cannot be done without permitting more flexibility and a more rapid rate of appreciation of the exchange rate.

The ceiling imposed on interest rates paid on savings deposits is a major factor behind the low cost of capital, keeping the bank lending rate low and holding down the opportunity cost for enterprises' use of their retained earnings for investment. This ceiling needs to be lifted. In turn, a higher cost of capital along with a stronger currency will help curb overinvestment in export and import-substituting industries. Real household incomes would also be boosted by increases in both bank deposit rates and the exchange rate. Consumption would rise as a consequence.

Financial market reform is also needed to improve the intermediation of savings in China. Lifting the cap on deposit rates would not only help push up the cost of capital, it would also increase competition in the banking sector and provide incentives for banks to expand credit to new customers. Bond and equity markets need to be more fully developed to provide alternative sources of financing for firms and a much broader array of assets for households to invest in. Small- and medium-sized firms have had to rely largely on retained earnings or the assets of their owners to finance investment. Consumers also have had limited access to credit. Better credit access and higher yielding assets to invest in would reduce household saving and raise household incomes over time, boosting consumption.

The government also has an important direct role to play in rebalancing the economy. It has to continue improving critical social services, especially education, health care, and pensions. Reducing the uncertainties surrounding the provision of these services will substantially diminish households' strong precautionary savings motive and give households the confidence needed to raise consumption.

¹⁷ Chinese premier Wen Jiabao in his address to the National People's Congress in March 2007 said that "the biggest problem in China's economy is that growth is unstable, unbalance, uncoordinated, and unsustainable."

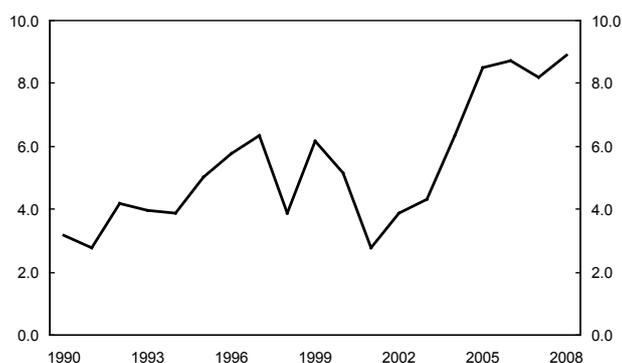
Prospects for New Zealand

In this less favorable external environment, a small, open economy like New Zealand faces uncertain prospects. Two specific questions bear consideration: what will become of New Zealand's large current account deficit and what can New Zealand do to cope with slow and potentially volatile growth in the rest of the world?

The key to assessing implications of the current account deficit for New Zealand's future is to understand the sources of the deficit and how it is being financed (Figure 8). New Zealand's current account deficit does not really look to be part of the problem of global as defined in this paper. Structural problems in New Zealand's economy do not appear to be a factor contributing to the deficit. Looking at macroeconomic level data, the deficit also does not appear to arise from a basic imbalance between savings and investment. However, problems with the macroeconomic data make it difficult to draw firm conclusions.

Investment rose over the period 2000-2008, accounting for a significant part of the increase in the current account deficit. Roughly half of the rise in investment was in housing. To a significant extent, the increase in residential investment served to meet the needs of a growing population owing to rising immigration. It also may have reflected some business investment since non-corporate farming is included in the household sector, and there were significant increases in productive capacity in this sector with the rise in commodity prices.

Figure 8. New Zealand: Current Account Deficit
Percent of GDP



Source: International Monetary Fund, World Economic Outlook 2009

Concerns have been expressed about the level of household savings and the large amount of debt households took on during the 2000s. Some distortions created by tax policy explain part of this behavior, but how important they were in influencing households' decisions to save less than they should have or to take on more debt than they can reasonably be expected to service is not clear. With the limitations imposed by the weaknesses in macro data, it is important to expand research using micro data to better explain savings and investment behavior and to broaden understanding of the forces that drove the rise in the current account deficit. Such research should also provide valuable insights as to how government policies may have played a part.

Some indirect evidence as to whether a serious imbalance existed between savings and investment can be inferred from the behavior of New Zealand's exchange rate. If domestic demand in New Zealand (particularly driven by low savings) had been a major factor behind the rise in the current account deficit, then it would have been expected that the exchange rate would depreciate. Instead, the exchange rate appreciated strongly over the period after 2006 when the current account deficit was rising sharply. This currency appreciation suggests that it was capital flowing into New Zealand that in effect pushed the current account into a larger deficit. In part, this capital inflow reflected increased movement of funds through the channel normally used to finance New Zealand. Historically, the bulk of external financing for New Zealand has been provided through the banking system. In recent years, New Zealand banks tended to borrow in U.S. dollars and then use currency swaps to offset the foreign exchange risk. From the banks' perspective, they are essentially borrowing in New Zealand dollars, while their foreign lenders see themselves as having U.S. dollars loans.¹⁸ The rise in inflows through this channel during the 2000s reflected New Zealand riding the wave of cheap U.S. dollar financing produced by the global savings glut. The relatively short-term nature of this financing, however, exposed New Zealand to significant liquidity problems when the financial crisis hit in the second half of 2008.

The rise in capital inflows also reflected increased demand for New Zealand dollar-denominated assets. In a world where investors were hunting for low risk assets with higher returns, New Zealand became a desired destination. The differential between U.S. and New Zealand interest rates widened significantly during the mid-2000s. This differential was perceived by investors as overstating the underlying risk of default of New Zealand dollar assets and, at least initially, the risk of an adverse movement (an depreciation) in New Zealand's exchange rate. The result was substantial inflows through the issue of Uridashi- and euro-kiwi bonds.

In recent months, the direct flow of financing into New Zealand dollar assets has diminished substantially, with net redemptions of Uridashi and euro-kiwi bonds rising. U.S. dollar funding, however, has risen somewhat as

¹⁸ The swap portion of lending transactions also should provide the offshore lenders with additional assurances that they essentially have U.S. dollar assets and have not acquired foreign exchange risk indirectly. This and the creditworthiness of New Zealand banks (and their Australian parents) explain why the banks can operate in the interbank U.S. dollar market on relatively favorable terms. In sharp contrast, consider Austrian banks, for example, that lent in euros to Eastern European residents. These banks may have thought that they did not have foreign exchange risk, but they have found out that they have acquired such risk indirectly because of potential difficulties the borrowers may face in acquiring the euros needed to service and repay these loans.

world financial markets have returned to more normal conditions and New Zealand banks have restored some of the funding that they previously lost. The sharp exchange rate depreciation in early 2009 largely reflected the disruptions in world markets. With restoration of access to dollar funding in recent months, the value of the New Zealand dollar has risen back toward its previous level. However, with demand in New Zealand subdued and likely to remain that way for some time, the exchange rate would be expected to decline in the period ahead, slowly growing domestic loan demand would reduce the need for New Zealand banks to raise offshore funding.

Financing through the U.S. dollar market will remain available for New Zealand, but there could be periods of volatility depending largely on how the United States deals with its fiscal position over the medium term, and the willingness of investors to continue to park large amounts of funds in U.S. dollar assets. It appears likely at least in the period immediately ahead as China clings to heavily managing its exchange rate that demand for U.S. dollar assets will remain strong. At the same time, the push that came from capital inflows and raised New Zealand's current account deficit will diminish, and the deficit can be expected to fall back to significantly lower levels, especially as domestic demand grows more slowly. New Zealand in effect has been a small bucket dipping into the large lake of demand for U.S. dollar assets, and it should be able to relatively easily finance its reduced current account deficit going forward. But it cannot take its relatively small size for granted and simply assume that financing will always be there. Financing will be available only as long as New Zealand continues to be very well managed economically.

In the end, it is obvious that there is little that New Zealand can do to escape the effects of the slow recovery in the world economy that is in prospect. It can also do little to change this outcome. With a slow world economic recovery, commodity prices can be expected to be relatively stagnant for some time, especially prices for the type of "soft" commodities that New Zealand produces. There is also a significant risk that New Zealand's commodity exports will face increasing protectionist pressures and subsidized competition from other countries in world markets.¹⁹ There is some hope that New Zealand's markets in developing countries in Asia will provide support for its exports. However, given the continued heavy reliance of these countries on the rest of the world—particularly the United States—to propel them, growth in these countries is not expected to be substantially greater than in the advanced economies.

To survive and prosper the best it can in such a hostile environment, New Zealand's economy will have to retain its considerable flexibility and adaptability. This is the only way a small, open economy will be able to cope with the stiff challenges that it is likely to face.

¹⁹ For example, the fall in dairy prices is already prompting pressures for greater subsidies in the European Community and the United States.

Concluding Remarks

This paper paints a rather gloomy picture of the prospects for world economic recovery and growth. Given present tendencies in major economies, it is extremely difficult to come to another view.

The United States among the major economies is the only one that is adjusting its savings and investment imbalances. Household savings have risen, and will rise further in the period ahead. Within the next two years, the U.S. Administration also will have to follow through on its commitment to consolidate the fiscal deficit, contributing to a significant rise in U.S. national savings.

At the same time, the slack in world demand left by slower U.S. growth is not likely to be picked up by any of the other major world economies. All of them have been and appear likely to continue to be heavily dependent on exports to drive growth. Europe is complacent and appears content to simply wait for growth in the rest of the world to lift it out of recession. However, in addition to the prospect of slow U.S. growth, Europe faces significant internal difficulties. Problems in Eastern Europe and increasing difficulties in Southern Europe will hold down demand growth within the region. In Japan, economic uncertainty and political instability are likely to continue to suppress domestic demand. In the rest of East Asia, countries will also continue to depend heavily on exports to generate growth. China, in particular, looks likely to continue to lean heavily on exports to sustain relatively rapid economic growth.

Hence, prospects for world growth are gloomy, but they do not have to be. Steps that each major economy needs to take to boost their long-term growth prospects (and prospects for the world economy) are well known and have been discussed at length for many years. What is needed is recognition of the situation by the political authorities in these economies and the will to act and do what is after all in the best interests of each and every one of them. How to spark the necessary actions unfortunately looks likely to remain the major question, as it has been for the past several years.

In the meantime all a small, open economy like New Zealand can do to survive is to continue to follow policies in its best interest — stay flexible and adaptable in order to be able to deal with the challenges that it will face. At present, New Zealand appears relatively well positioned to handle the challenges that it faces. But there is no room for complacency, and in particular, much could be gained by further research and scrutiny on how economic policies are affecting savings and investment behavior.



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