Rebalancing the world economy: a common challenge

Jean-Pierre Landau

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Great changes are taking place in the world economy. The center of gravity is moving to Asia and the emerging world. This has been recognized in the landmark agreement on IMF reform reached at the last G20 Ministerial meeting. China has become the IMF's third shareholder, India has moved up by five ranks and Brazil is now on par with Canada (a G7 country). Symmetrically, the European representation in the Board will be reduced by the equivalent of two chairs (out of nine currently held).

At the same time, we are facing great challenges. Output is growing fast in emerging economies but this relative shift in production has not been fully matched by a rebalancing in demand. Overall, beyond the turbulences caused by "hot money", net capital flows are going "uphill" from emerging to developed economies. That means that some of the poorest citizens of the world are lending money to some of the richest, allowing those to finance their consumption. And financial bubbles have tended to proliferate in an environment of permanently low inflation and ample liquidity.

I will argue that those phenomenons can all be ascribed to two common causes: a worldwide based shift in the primary distribution of income; and asymmetries in financial development among countries. Together, they combine to produce (1) excess saving in emerging economies (2) strong capital inflows to the US (3) an increasing frequency in financial booms and busts and asset price bubbles in both advanced and emerging economies.

Let's look first at income distribution. In China, the share of wages in GDP has declined from 55% in 1992 to 48% in 2008. In the US, the median real wage has been stagnant over the last fifteen years despite the fact that real GDP has grown annually by above 3% over the same period. These are deep changes mostly driven by technology and demographics, in proportions which are hotly debated, and partly unexplained.

In contrast to wage developments, consumption trends have been widely divergent. In China, the share of consumption has gone down by more than 10 % of GDP over the last decade. In the US, consumption kept growing (both in absolute and in GDP share) fueling the demand for imports. Households in the US could consume more and save less because they

[1] in preparing those remarks, I was very influenced by the works by Ricardo Caballero and Raghuram Rajan (see references) among others. All interpretations and errors are mine.

felt richer. And they felt richer because the value of their houses and financial assets was rising at a quick pace and that trend was expected to persist. Broadly speaking, the worldwide equilibrium between demand and supply of goods was based on a continuing asset price bubble in the United States.

Considering now financial development, another kind of imbalance shows up. The global rise in savings, especially in the emerging world, has not been matched by an equivalent increase in the supply of safe and liquid financial assets. This "asset shortage" is one fundamental reason why bubbles have erupted in many countries with increasing frequency, either in real estate or financial markets or both. It also had a strong impact on the direction of capital flows. Only the US economy has the ability to generate liquid and safe assets in significant quantities. US capital markets act naturally as a magnet for world savings, especially for foreign exchange reserves. In addition, financial engineering allowed US institutions to manufacture complex products which looked apparently safe, but proved very fragile. Admittedly, internal imbalances and huge deficiencies in supervision and regulation played a role in the run up to the crisis. But the process has been largely driven by capital inflows in the US looking for an improbable combination of liquidity, safety and high returns.

Combining all these evolutions gives a good picture of the structural forces behind the crisis. Worldwide shifts in income distribution generated excess saving, which were compensated by wealth effects borne out of increases in asset prices. Since those transformations were asymmetrically distributed around the world, they were accompanied by growing imbalances and capital flows. Obviously, purely domestic factors, especially in the US played a major role in amplifying the underlying imbalances. But, ultimately, the crisis was borne out of structural changes in the world economy and our collective inability to adjust.

Looking forward, many features of the pre-crisis environment will still be with us. Emerging economies will still be saving a high proportion of their income. A significant part of those savings will be invested in foreign exchange reserves. Downward pressures on wages will subsist. There are signs that wage dynamics are changing, especially in China, whose economy is deemed by many analysts to have reached the "Lewis turning point" where demographic pressures are offset by increased demand for (at least) qualified labor. Nevertheless, the process will likely be very gradual. As for advanced economies, biased technical progress and pressures from the emerging world as well as unemployment may work to constrain wage dynamics. A general sense of economic insecurity will lead to increase in savings. In most countries and especially in Europe there is an urgent need for strong fiscal consolidation. Market discipline will act powerfully to impose strong consolidation of public finance over an extended period of time.

Therefore, it is a valid question to ask: where will growth in world demand come from in the future ?

This may sound paradoxical. In most of the emerging world, demand seems to be booming, and, for many analysts future economic growth will be primarily constrained by the scarcity of natural resources and environmental pressures. These are real and unprecedented and they call for a new technological revolution. I am optimistic. History has taught us that

Malthus and its intellectual descendants have always been proven wrong. The whole process of economic growth was borne out of the ability of mankind to overcome scarcity through human inventiveness and technical progress. It won't be different this time.

I am also very optimistic in the long run on the fundamental rebalancing of the world economy. Income per capita levels in the emerging world will progressively converge to those of the advanced economies and this will present gigantic market opportunities for producers in those countries. At the same time, tensions and insecurity created by differences in income and productivity levels will abate and disappear.

The transition process, however, may be bumpy. Unavoidably, advanced economies, especially in Europe, will have to adjust to the permanent shift in world comparative advantages. They will have to increase flexibility and, above all, develop and preserve their most precious resource - human capital - through education and excellence in research. Emerging economies will have to face the dual challenge of aging and reducing inequalities.

During that transition period, which may last several decades, it is important that the whole process is not derailed by shocks and crisis borne out of imbalances in the world economy. This is where the twin questions - (1) of the level and distribution of global demand and (2) the level and allocation of world savings - may matter most.

Inside the G20, there is broad agreement on the need to rebalance aggregate demand. That shared objective creates cohesion and has played an essential role in 2008 and 2009 in restoring confidence and setting the path for the recovery.

The debate is still going on, however, on three major and interrelated issues : first, the appropriate pace of the rebalancing, with advanced countries feeling a greater sense of urgency; second, on the most efficient strategies, in particular regarding exchange rates; and finally, and more broadly, on the best international financial and monetary architecture.

I would like to offer some tentative reflexions. These are purely personal thoughts, although I will try to put them in perspective with the incoming French Presidency of the G20.

Rebalancing global demand will not be an easy task.

Simple arithmetic and size effects show the amplitude of the challenge. At the word level, to compensate one for one for a decrease of 1% in US consumption, Chinese consumption has to go up by 7%.

In addition, saving behaviours are deeply rooted in cultural and demographic structures of our societies. In western countries, consumption can be seen as the ultimate objective of economic activity, as well as the fundamental measure of welfare. Other countries may have different preferences. In a speech one year ago, Governor Zhou pointed to the fact that " East Asia countries are influenced by Confucianism, which value thrift, self-discipline, … and anti-extravagancy ". In a period of aging, thrift will be seen as a necessity as much as a virtue. Shifts in income distribution might not happen fast if strong structural forces push in

the other direction. Public policies (fiscal, social safety nets) certainly have a role to play, but they take time to redeploy and implement.

Finally, consumption patterns differ across countries and are strongly influenced by differences in taste and level of developments. So, global rebalancing in consumption requires a change in production structures. That change will not – and should not – occur overnight. Attempts to speed up the process would only result in major disruptions and increased volatility. Rebalancing will be progressive but should start now. It cannot be achieved without some adjustment in relative prices. In market economies, it is important that producers face the right price environment when they make long term decisions about investing in technology and productive capacity. Countries are free – and should remain free- to choose whatever exchange rate regime and policy suit them best, taking into account their specific national circumstances. Real exchange rate adjustment, however, is an integral part of a global and orderly rebalancing strategy. That wisdom is best embodied in one of Governor Hu Xiaolian's speeches, last July, where she demonstrated how domestic factor price and exchange rate adjustments are both substitutes and complementary.

Many interactions between our economies occur through capital rather than good markets; This is normal in a "multipolar" world given the diversity of countries, with different preferences, demographics and levels of development. Some of us save more than we spend. Others need capital to finance their growth. Many are aging and want to secure their future income through good and safe returns on their investments. We therefore share a common interest in well functioning global capital markets. Asymmetries in financial development prevent us from reaping all the benefits of our savings efforts.

These asymmetries exist for good reasons. In many emerging economies, the memories of the 1997-98 crisis are still there. They lead to precautionary behaviors and a very cautious approach to capital market liberalization. Obviously, the case for unrestricted financial development and market liberalization has been somehow weakened by the crisis.

Nevertheless, we might be paying a heavy price for the disorganized state of our global financial and monetary system. While real interest rates are historically low, many investments with high returns are not undertaken. Poor and emerging economies growth is, in many cases, constrained by lack of infrastructure. We may face future shortages in many essential commodities because of insufficient investment in the current period. Differences in financial systems also exacerbate capital flows and exchange rate volatility, especially when, as is the case today, monetary policies are widely divergent across countries. Surely, we can do better in the future.

Full harmonization and total convergence in financial development between different countries is neither desirable nor feasible. But ensuring that our different financial systems interact harmoniously should be a priority. There are four possible avenues for progress.

First, greater convergence in financial regulation approaches between advanced and emerging economies. Significant advances are being made. China, together with Brazil and India has been, for a year, a full member of the Financial Stability Board, and as, such, participates in steering and leading the effort to build a more resilient and efficient global financial system.

Second, we may start thinking about ways of dealing with international capital flows volatility. For one given country, capital controls may temporarily reduce the pressure on its capital account or even permanently limit the volatility of its exchange rate. For the whole international system, however, they may simply displace the pressure to other countries or asset classes and exacerbate, rather than reduce, overall volatility. There might be ways to eliminate those negative effects by creating a predictable framework defining the circumstances, modalities and conditions trough which temporary or permanent controls would be implemented.

Third, it is important that countries which decide to open their capital markets be adequately protected against external financial shocks. Emerging countries have constantly sought to expand their foreign exchange reserves from 4 percent of GDP in 1190 to over 20 percent on average today. Reserves act as precaution against possible abrupt capital outflows. They also serve to provide liquidity to domestic financial institutions. They are used as a tool for internal - as well as external - financial stability.

The need for national reserves could be reduced if credible mechanisms exist to provide for the supply of official liquidity on a multilateral basis. Hence the current search for financial safety nets which has taken first stage in the G20. Significant progress has been achieved in this direction during the recent period with the creation by the IMF of new facilities and a new SDR allocation, the biggest ever, for the equivalent of 250 bn USD. More needs to be done and work should be undertaken to find sources of international liquidity truly substitutable to reserves without creating undue and excessive moral hazard.

And, finally, an important question is to find, in the future ,reliable international stores of value**. T**he crisis has amplified the "asset shortage" as some instruments, up to now considered as riskless, have proved very vulnerable to changing financial conditions. The ability of the private sector to create “safe” assets through financial innovation has proved largely illusory. So, in the period to come there may be both an increased demand worldwide for risk free assets and much less certainty on their future supply.

The search for a reliable international store of value has been going on for many decades. When discussions were held to build the Bretton Wood system, Keynes proposed the creation of a new international currency, the "bancor" which could serve both as a source of liquidity and a store of value. Thirty years ago, there was extensive discussion in the IMF on the creation of a substitution account. Most recently, in 2009, Governor Zhou has reopened the debate and suggested, over the long run, the creation of a new "super reserve" currency, while, in the meantime, enhancing the role and status of the SDR.

There are good arguments to create international instruments providing a reliable store of value. There are also conceptual and political difficulties. A choice would have to be made as

to the true nature of the "super reserve currency”. Would it be a basket of existing monies such as the SDR today? Or would it be a new "fiat" currency? More fundamentally, a new reserve currency would, in fact, grant a collective guarantee against exchange risk. This guarantee would benefit surplus countries and would be given by deficit countries. When the substitution account was discussed more than 25 years ago, it became clear, at the time that it would have to be part of a package encompassing explicit, binding and symmetric rules on balance of payment adjustments. Most likely, the same questions would be raised again today and the creation of a new reserve currency would have to be part of a broader framework. That may take time, as our Chinese colleagues are fond of reminding us when we discuss those issues.

In the meantime, financial development in emerging economies can go a long way towards expanding the range of safe and liquid financial assets available to domestic and international investors. Capital markets in local currencies have developed significantly over the last decade as fiscal positions in emerging countries have dramatically improved. There seems to be considerable scope for regional financial and monetary arrangements to prosper in the future. Those huge pools of savings currently available can be intermediated locally instead of going through financial systems located in advanced economies. Regional financial markets would have to complemented and underpinned by monetary arrangements. Asian countries are working on and implementing progressively such schemes through the Chiang Mai initiative.

We, in Europe, monitor closely those evolutions as well as the progressive emergence of the RMB as an international currency. As you know, we have a long and successful history of economic, financial and monetary integration. We have learned a lot and, still recently, gone through many crises and difficulties. Nevertheless the Euro, which did not exist fifteen years ago, stands today as one of two major world currencies. We certainly don't pretend our own experience should constitute a model or an example to be followed. I have, however, one certainty: a strong and permanently renewed spirit of cooperation has allowed us to overcome many obstacles and to reap many benefits in terms of prosperity and stability. In a world full of opportunities, but also increasingly complex, this may be an inspiration for all of us.

I thank you for your attention.

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