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ASIAEUROPE ECONOMIC FORUM

Global Governance of Public Goods:
Asian and European Perspectives
12th edition

Sessions summaries

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ASIA-EUROPE FOUNDATION

The AEEF is organised with the financial support of the Asia-Europe Foundation (ASEF) which promotes understanding, strengthens relationships and facilitates cooperation among the people, institutions and organisations of Asia and Europe.

SESSION 1 - THE RETURN OF GLOBAL IMBALANCES

*Chair: **Naoyuki Yoshino**, Dean, ADBI*

Giancarlo Corsetti, Professor, Cambridge University

The return of global imbalances?

1) The landscape of the international financial system

If we focus on the global view of the international financial system some interesting facts emerge. First, we notice a growth of gross assets and liabilities (stocks) of which most are non-contingent debt contracts. An enormous increasing of international and global banking which increases the risk of global liquidity pushes these contracts forward. Furthermore, the institutional investors and asset managers have a portfolio strategy that is often constrained by institutional rules and market practice. We find little evidence of increasing cross-border risk sharing. In fact, we observe the opposite: accumulation of imbalances and debt financed bubbles, and increasing endogenous risk.

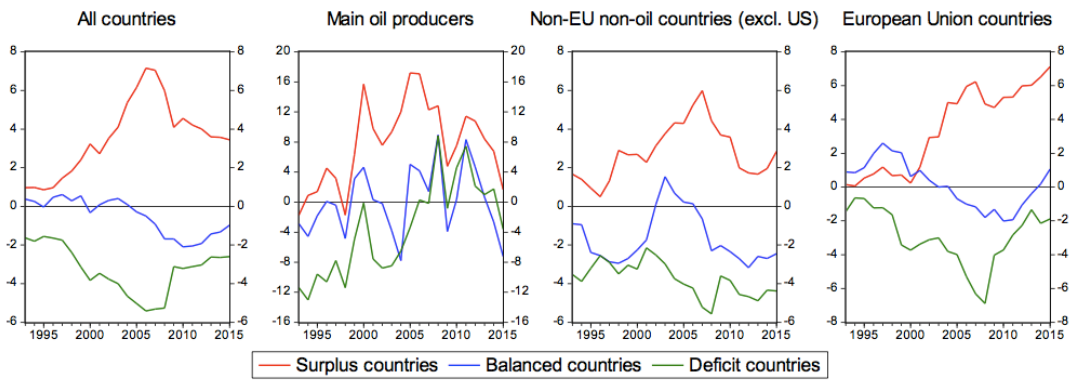
A second fact is related to the composition of countries portfolio. It differs by maturity, currency of denomination and type of assets. Only few countries can issue debt in their own currency and therefore have to borrow in dollar or euro (original sign). As a result, in most deficit countries, exchange rate depreciation may not foster adjustment to negative current account shocks. The adjustment happens rather via employment and income.

2) What about global imbalances?

In its original formulation, global imbalances were related to concerns with persistent US deficit vis-à-vis EME (mainly Asian) countries, foreshadowing a run on the dollar. This assumption of a dollar crisis has been either discarded or proved wrong.

Furthermore, as the graphs below illustrate, deficits (flow) fell sharply with the crisis.

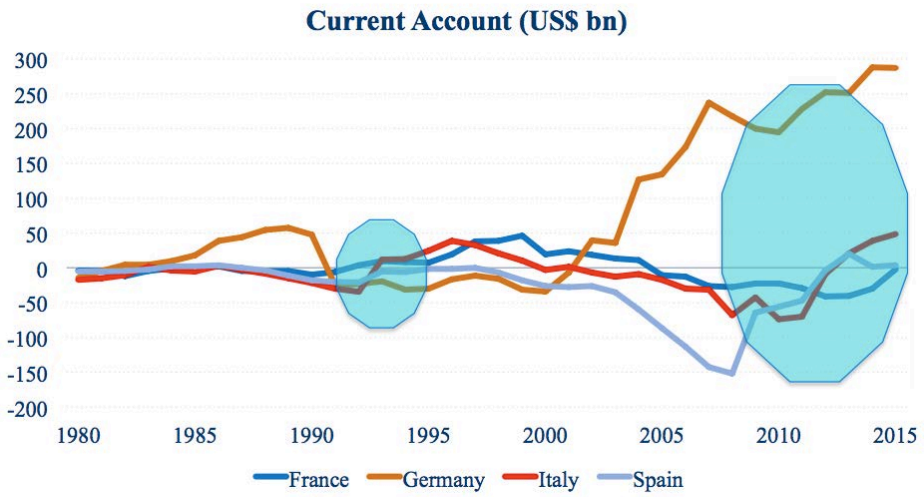
Figure 1: Global current account balances (% GDP), 1993-2015



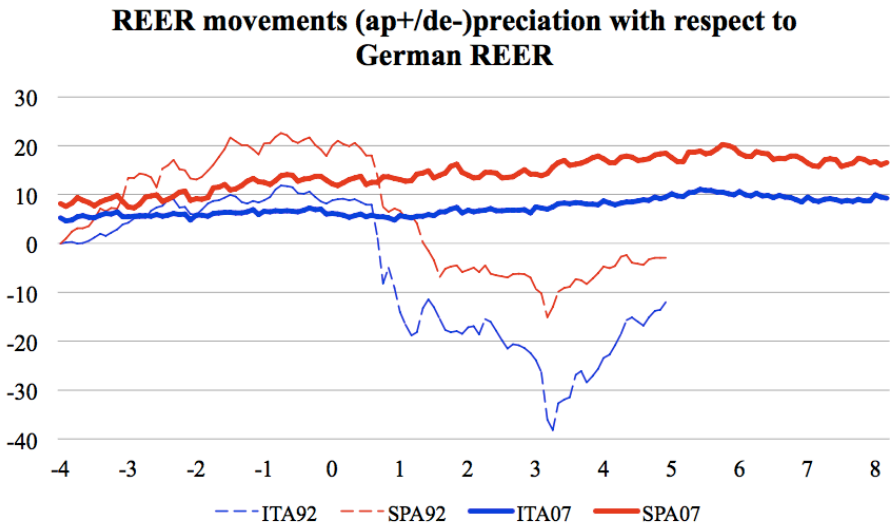
Today global imbalances are a stock not a flow problem, which implies debt over-hang, financial fragility and fiscal sustainability issues. We can identify two main issues: a reduced stabilization capacity and a lack of institutional development at both national and international levels.

3) The Eurozone: a tale of two crises of imbalances 1992-93 (or 95) currency crisis vs. current crisis

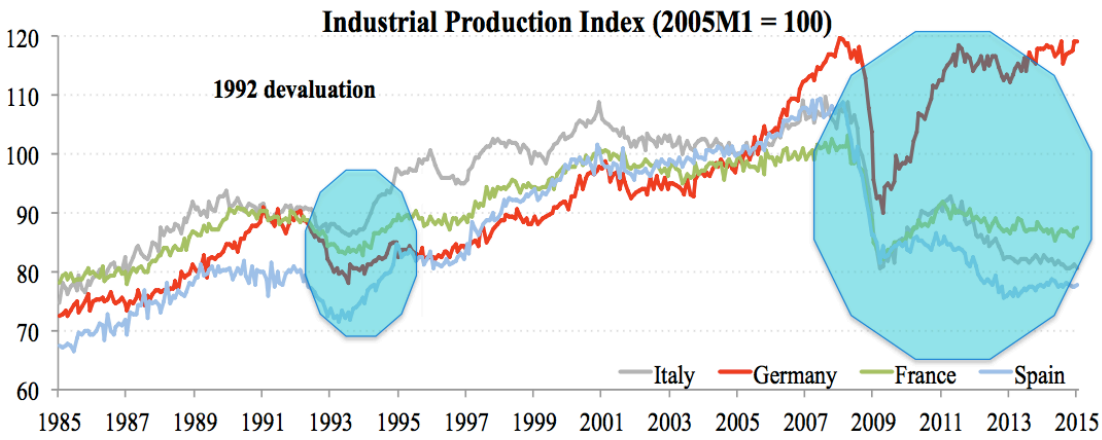
The graph below illustrates the current account evolution of France, Germany, Italy and Spain. We observe that the amplitude of the imbalances in the 92-93 period was much lower than today's.



The graph bellow shows the real effective exchange rate (REER) movements of Italy and Spain with respect to the German REER, O the x axis represents the time of the crisis with the negative (positive) numbers being the years before (after) the crisis. As we can see, only during the 92/93 crisis, Italy and Spain had deep real exchange rate devaluations.

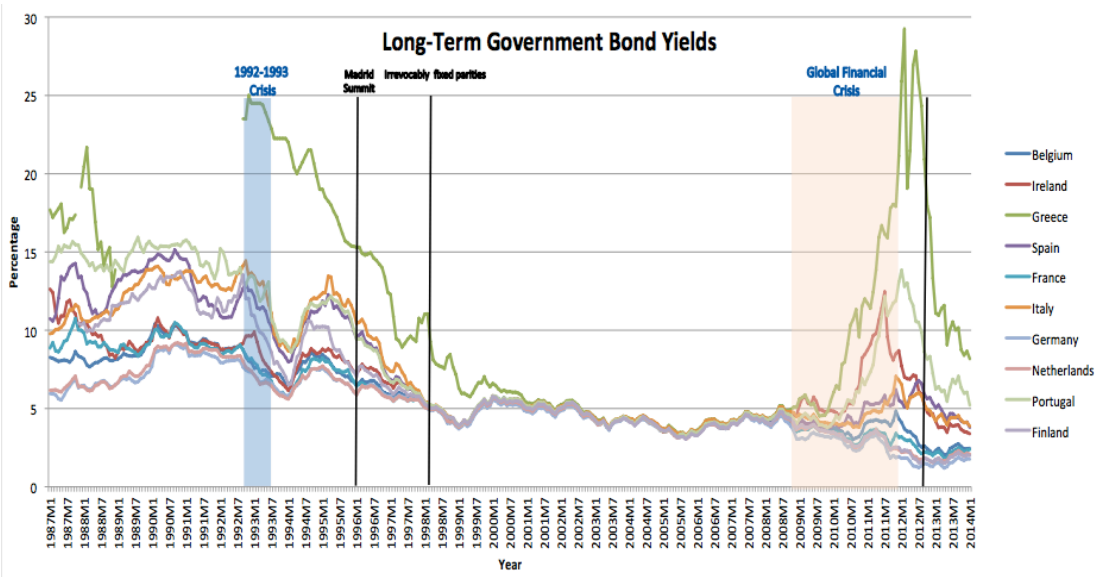


Furthermore, oppositely to the current crisis, it does not seem that the 92/93 crisis had any impact on the industrial production.



In sum, during the 1992-1993 (95) crisis there was a better EZ stance, with Germany running large deficits post-reunification. There were also more adjustment margins with the possibility of exchange rate adjustment, moderate inflation allowing wage and spending adjustment and large banks bailouts. These instruments aforementioned were, nevertheless, costly to use demanding high interest rates to fight currency instability and enormous fiscal retrenchment to help financial stability, finance costs of crisis and correct imbalances. However, these domestic adjustments following the 92/93 crisis, which were helpful, could not end the crisis itself. Only in December 1995, with the Madrid summit, a renewed political cohesion was established and the crisis solved.

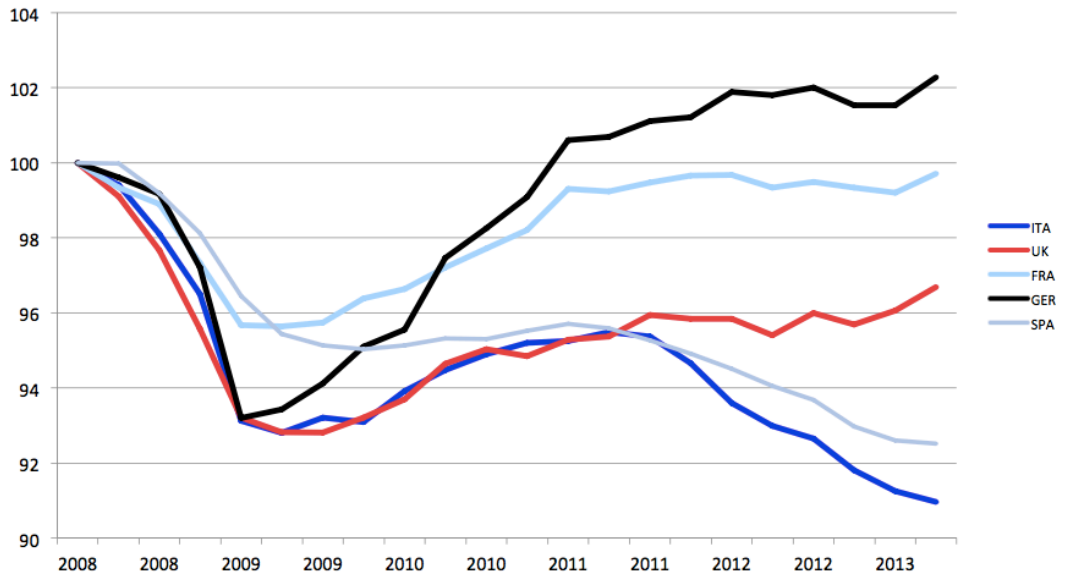
The graph below illustrates the impact of the political cohesion on the long-term government bond yields of different European countries.



The current EZ crisis has different aspects. First, Germany runs large surpluses. Second, because of the common currency no exchange rate adjustment is possible. Third, debts are denominated in euro, hence a fall in prices help competitiveness but worsens debt burden. Finally, the inflation is closer to zero than to the 2% target.

The paradox of an “incomplete monetary union” raises the benefit from coordinated policy. As a matter of the fact, incomplete institutional development worsens the conflict among states worsens and raises the temptation to pursue opportunistic

policies. The current problem is institutional and has been costly to Europe (see graph below of the GDP evolution of five European countries, 2008 = 100).



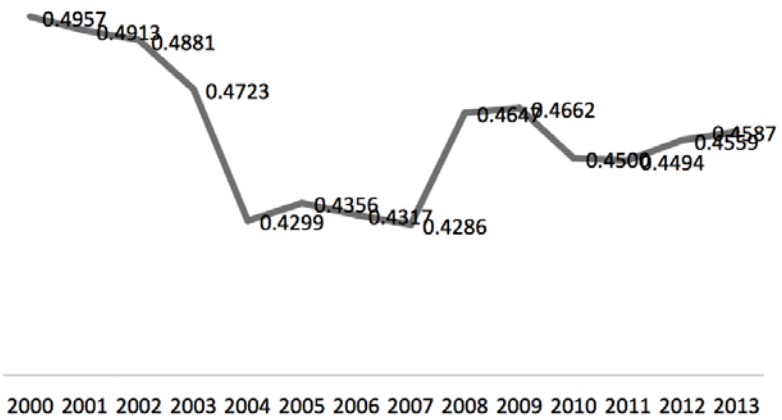
<u>Zhang Jun, Director of the China Center for Economic Studies, Fudan University</u>

China rebalancing

China's growth is expected to be less than 7% this year - its lowest level since the financial crisis. In fact, as a response to the 2008 financial crisis, the Chinese government set a stimulus package of fixed-asset investment that resulted in 9% GDP growth for two years. However, after 2011, stimulus was no longer sustainable and turned to macroeconomic tightening, causing investment growth to plummet, from a nominal rate of over 30% to about 10%.

Additionally, China's surplus has shrunk to 2% reaching its lowest level in nine years. In the third quarter of 2014, China presented a more stable balance of payments with its external surplus ($81.5 billion) almost matching its capital and financial account deficits ($81.6 billion).

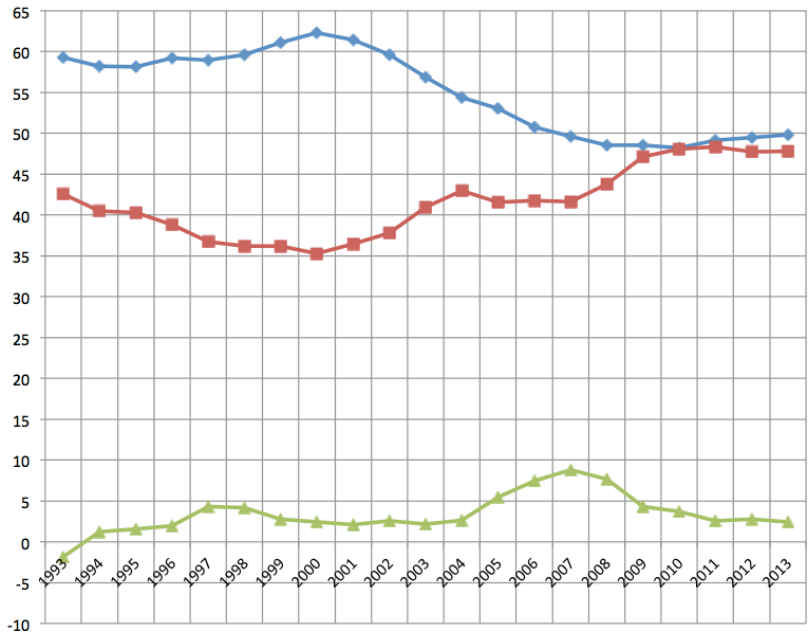
This rebalance can be explained by different factors. First, over the last two years, developed countries have been pursuing re-industrialization to boost their trade competitiveness. Nevertheless, China's wage costs are rising and its labor-intensive manufacturing industries are facing increasingly competition against other emerging economies. As a result, the recovery in the advanced economies is not returning Chinese export demand to pre-crisis levels.



China is also undergoing an internal rebalancing of investment and consumption. The expansion of middle class is having a major impact on consumption. Last year, the country surpassed Japan to become the second-largest consumer market in the world, after the US.

Chinese imports remain focused on intermediate goods, with imports of raw materials like iron ore having surged over the last decade. But, in the last few years, the share of imported consumption goods and mixed-use (consumption and investment) finished products, such as automobiles and computers, has increased considerably.

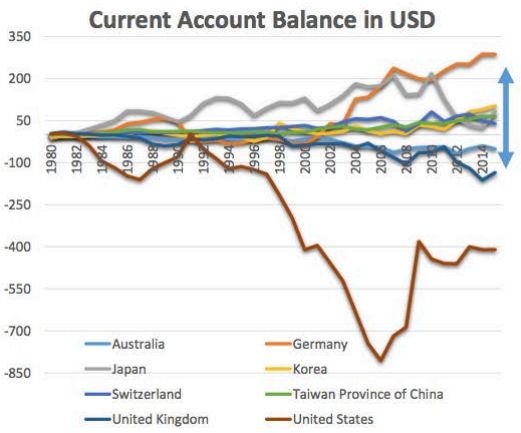
The graph bellow illustrates the evolution of China's expenditure components of GDP. The blue line represents the investment, the red line the consumption and the green line the balance of trade. As we can observe, over the past years consumption has been increasing, investment decreasing, and the balance of trade stabilizing.



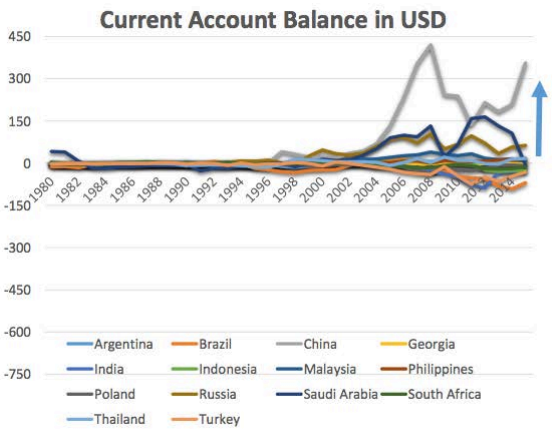
Il Houng Lee, former G-20 Sherpa for Korea and President, KIEP

Resurgence of Global Imbalance

As the graphs below illustrate, for different advanced and emerging economies, current account imbalances appear to be widening.

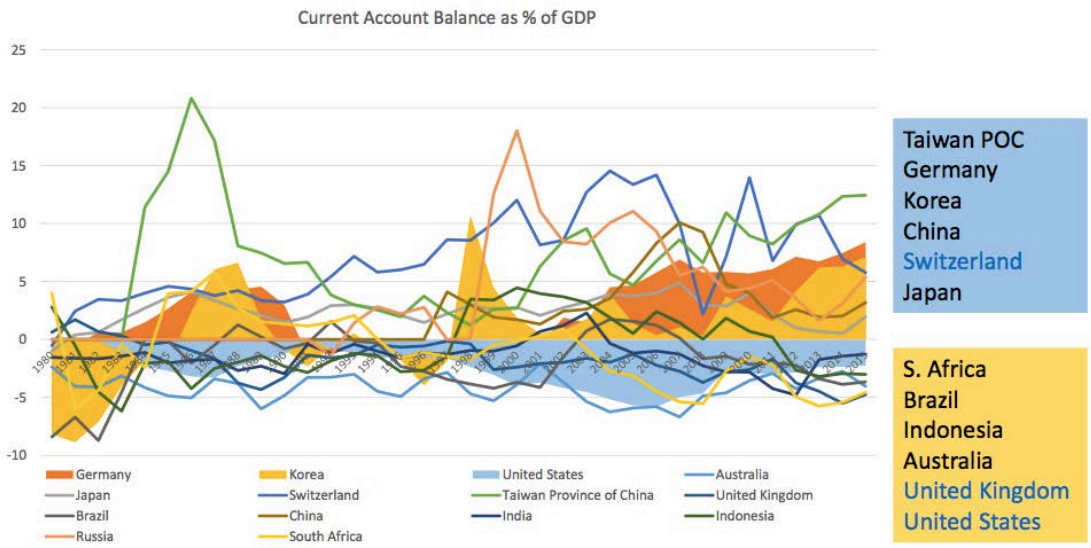


Source: WEO, IMF



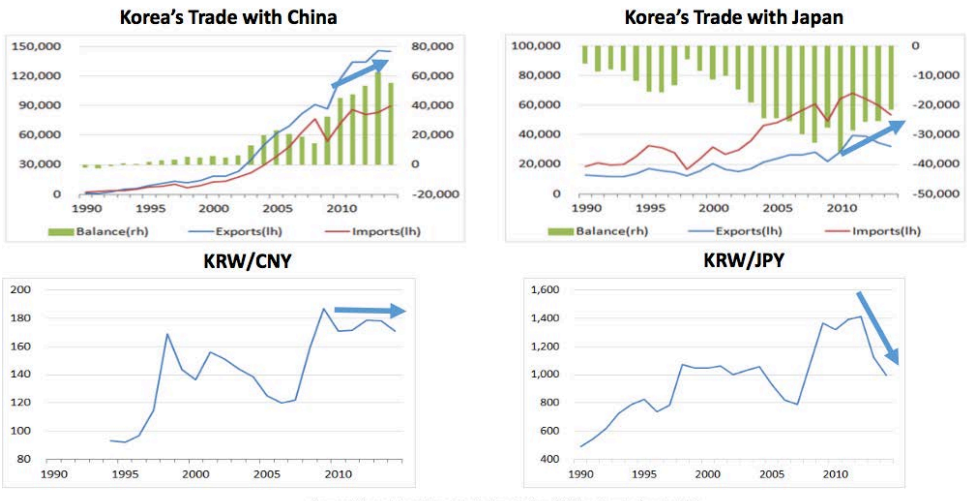
Source: WEO, IMF

There is a possible contribution of commodities prices to ampler imbalances. As a matter of the fact, prices of raw materials have declined sharply relative to manufacturing products. We observe that manufacturing (blue box) and commodity exporting (yellow box) countries seem to have deficits and surpluses, respectively.

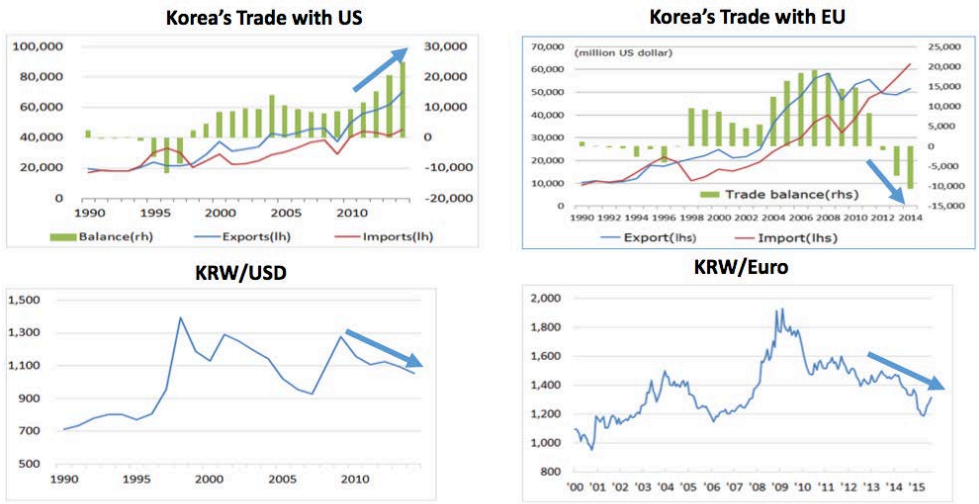


Source: WEO, IMF

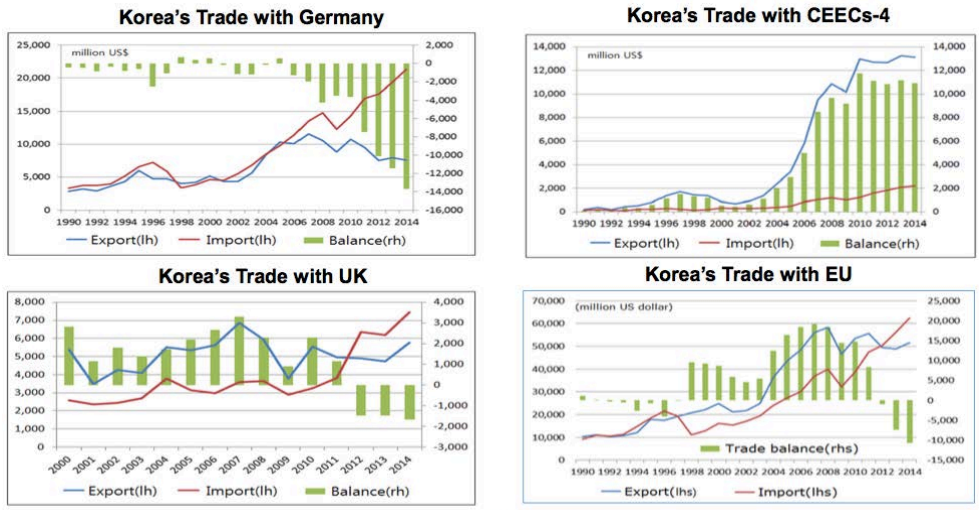
The trend in the last few years does not show a clear linkage between exchange rates and imbalances. In fact, bilateral current account balances reflect trading partner's characteristics to have played a more important role. As the following graphs illustrate for Korea, trade surplus with the US and trade deficit with the EU widened both during won appreciation relative to the USD and the Euro. Even within the EU, divergence of trade balances reflects the nature of trade relations in the country.



Sources: Korea International Trade Association, CEIC, and author's calculation

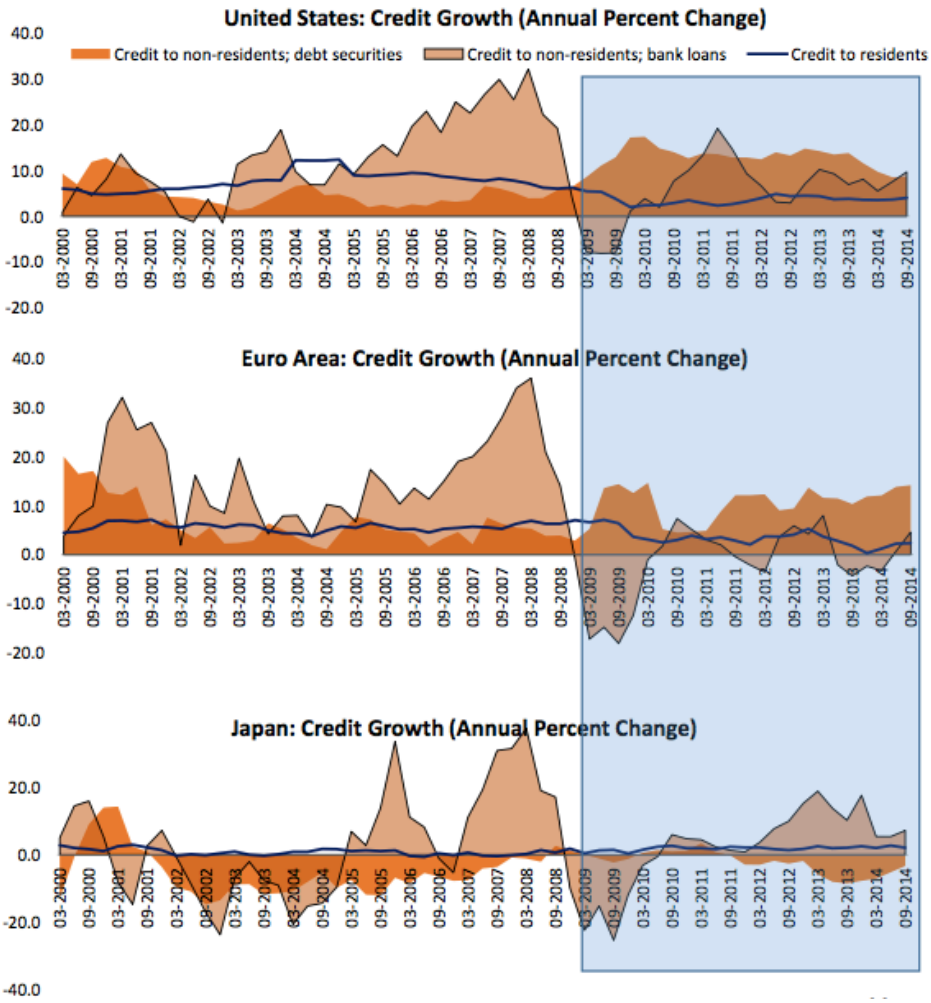


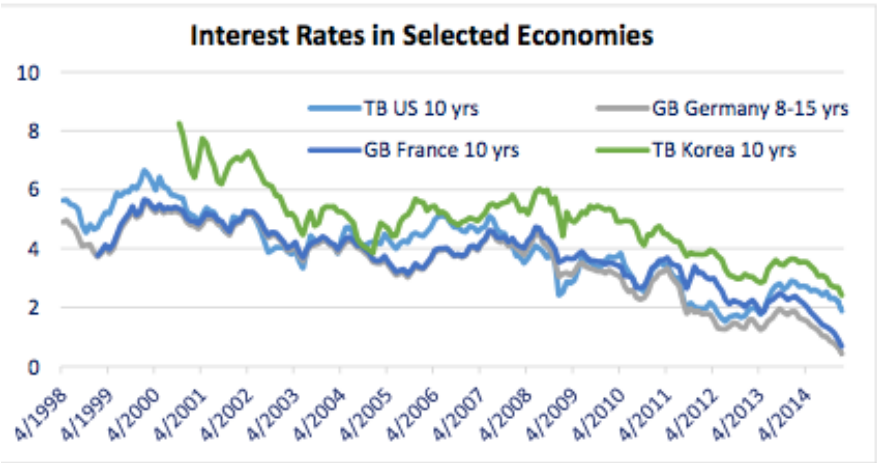
Sources: Korea International Trade Association, CEIC, and author's calculation



Sources: Korea International Trade Association, CEIC, and author's calculation

The evidence suggests that advanced economies' monetary policy stance have strong spillover to other countries not only through interest rate channel but also in actual flows. We observe that aggregate demand (AD) expansion of money in the US is matched by others advanced economies' AD expansion. Even Korea, for instance, that is a small country started to have its long interest rate in line with the US.

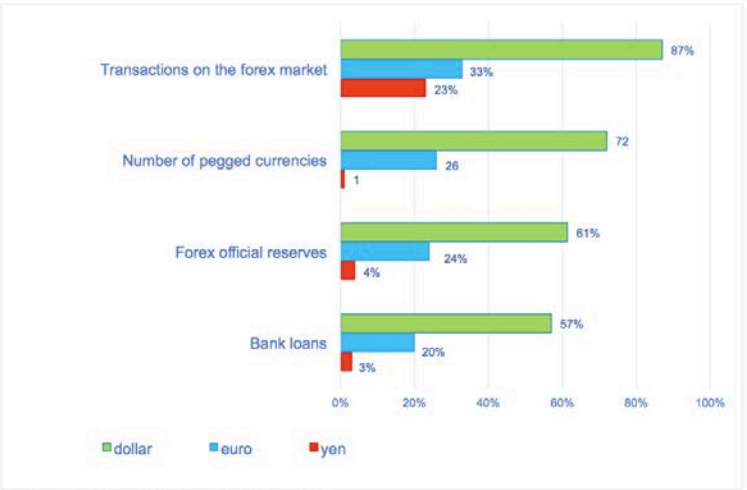




Finally, demographic aspects, such as ageing, should be considered when analyzing global imbalances. In fact, under the life cycle hypothesis of consumption, young households borrow against their future income, middle-age households save for relinquishing debts and retirement, and old-aged households spend their savings. Therefore, countries with a relative young or old population are more likely to run current account deficits, meaning that some imbalances are “inevitable”.

Natacha Valla, Deputy Director, CEPII

We have a conjunction of policy ideas on how to deal with global imbalances such as: bank union, capital market union (see Commission 30th September report), and investment plan. These ideas are conceived independently from each other. In fact, they address the common perception that there is a lack of market, infra structure, heterogeneity for the euro, which is a main international currency. As a matter of the fact, when we analyze the importance of the euro in the world economy, we observe that it represents roughly 25% of the global reserves. Additionally, it accounts for 33% of the transactions on the foreign exchange market, is the anchor currency for 26 countries and constitutes 20% of bank loans.



Source: Aglietta and Coudert (CEPII Policy Brief, *forthcoming*)

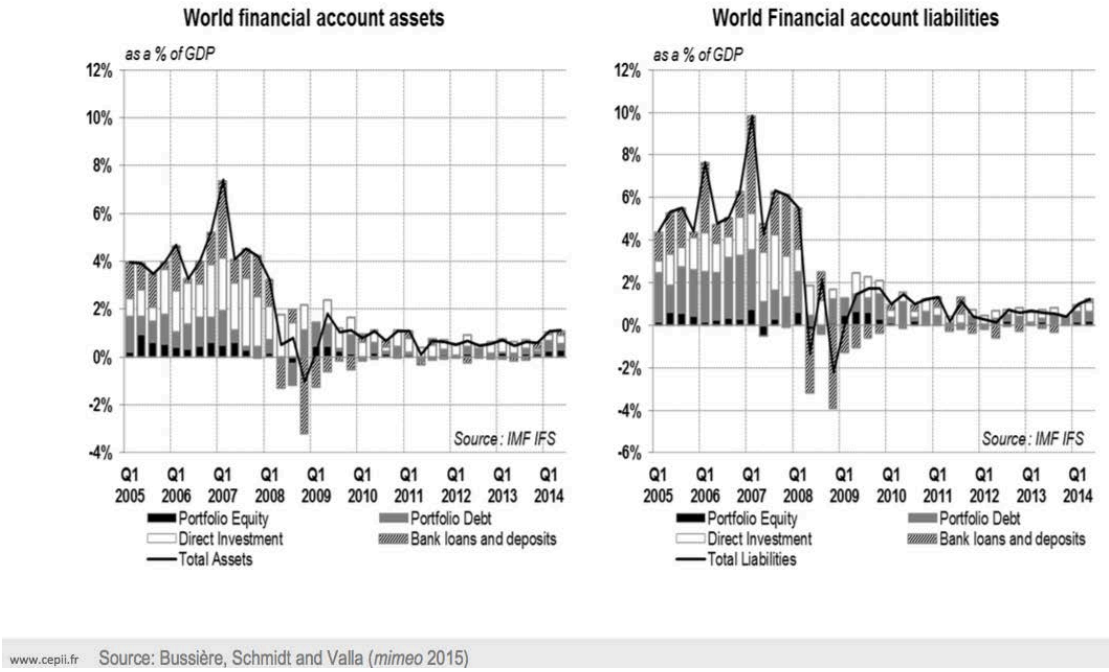
Is the euro going to be a residual to the USD and also to emerging market (EM) currencies?

We have seen that there are some limits to the USD system. First, due to geopolitical reasons there is mistrust with regards to the dollar. Second, the expansion of the EM-EM trade has diminished the overall importance of the USD. Third, few tools support EM currencies: currency swap agreements (i.e. China and Russia), own macro initiatives (i.e. financing of large scale investments projects, AIIB), genuinely strategic approach to international role of the FX (i.e. offshore RMB platforms), etc. Nevertheless, there are still vulnerabilities (Fed monetary policy spillovers, RMB internationalization, etc.).

Where does that leave the EUR 16 years on?

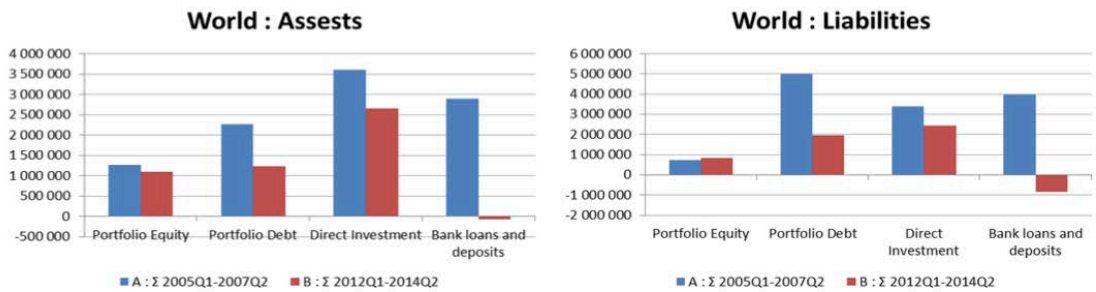
First, we have known a constellation of interest rates that would favor the greater role for the EUR as a funding currency. There is a cross stance between the ECB and the Fed low rates, sovereign spreads in the euro area are attractive (risky companies find it cheaper to fund in euro) and euro is a cheap currency thanks to the low interest rates.

To analyze global imbalances we gathered different data on the global finance. The first thing we note is a persistent shrinkage of international positions since the financial crisis.

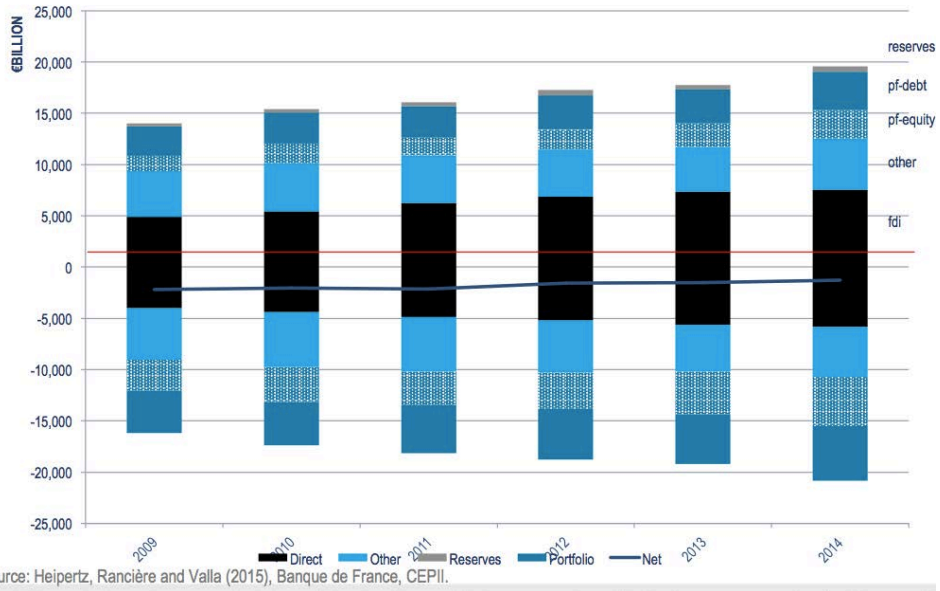


www.cepii.fr Source: Bussière, Schmidt and Valla (*mimeo* 2015)

We also see that flows have decreased and almost disappeared in bank loans and deposits.

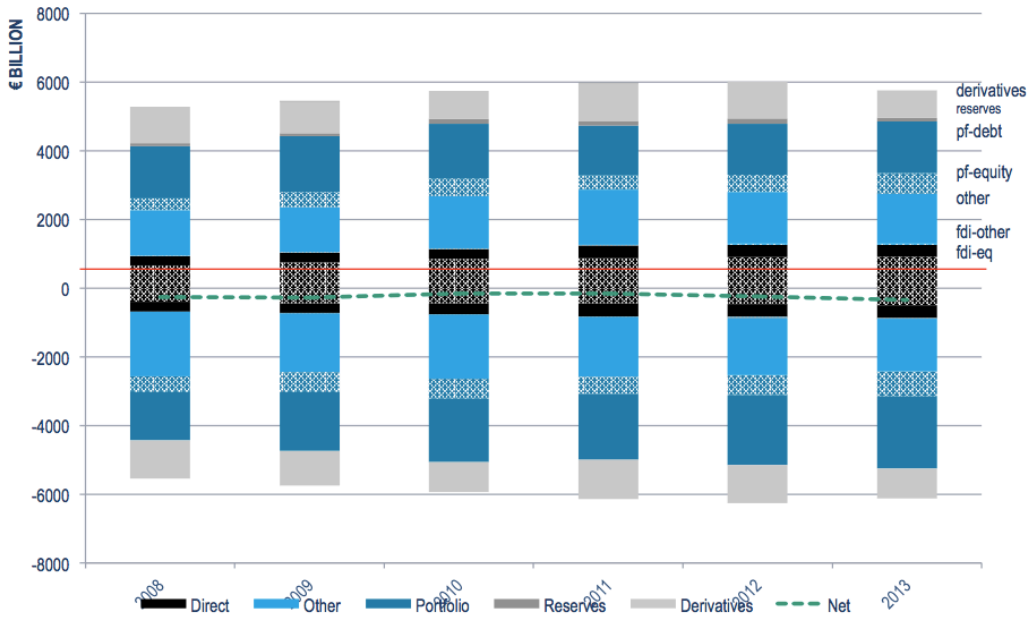


We can present some stylized “currency” facts from portfolio invest, taking the Euro area IIP as a background.



Source: Heipertz, Rancière and Valla (2015), Banque de France, CEPII.

In the French economy, the share of direct investment is lower that the Euro area, whilst the derivatives is greater.



Source: Heipertz, Rancière and Valla (2015), Banque de France, CEPII.