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**“Unwinding global imbalances: how much can we expect from structural reforms in
financial, product and labour markets?”**

**Jean-Philippe Cotis
OECD Chief Economist**

Introduction

John Lipsky has already provided us with a comprehensive overview of global imbalances. He gave us as well an excellent presentation of some of the policy options available to unwind such imbalances in an orderly manner. I will therefore try to concentrate on structural policies and their influence on current accounts.

This is not an easy subject, however. At first sight, it is not obvious that structural reforms have something to contribute to current account rebalancing. Warranted or not, skepticism may arise from various sources:

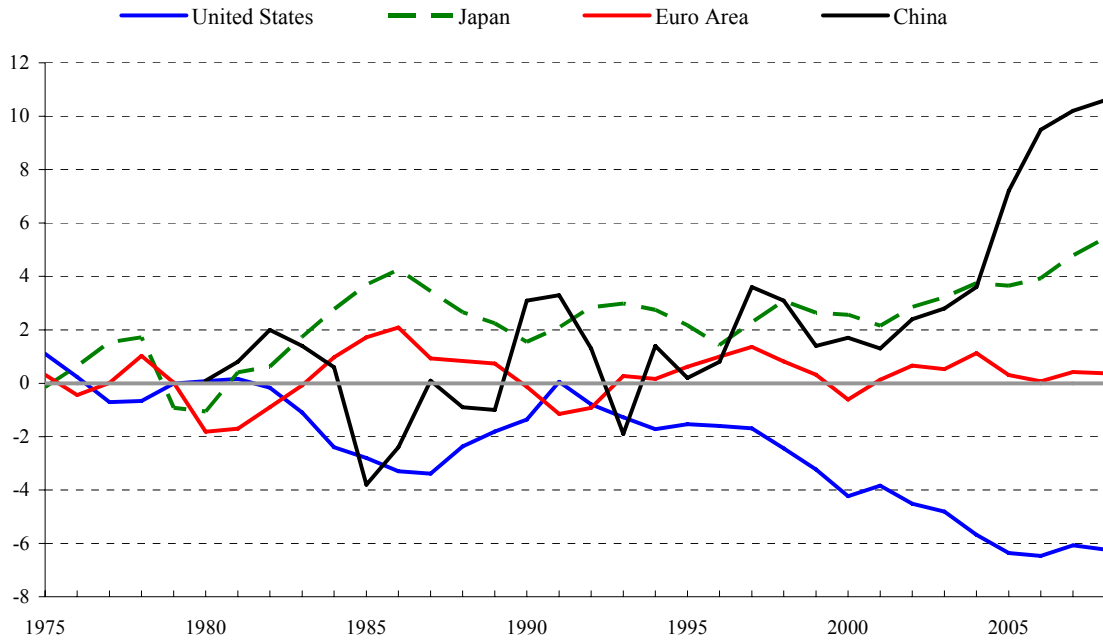
- Current account imbalances may not be an appropriate target for public policies, generally speaking;
- Current accounts may be a particularly awkward target for structural policies;
- Structural policies may have no influence on current account imbalances whatsoever.

Should public policies target the current account?

When capital is fully mobile and exchange rates fully flexible, there may be, in theory, little basis for worrying about current account imbalances. In such a world, current account imbalances should be the norm rather than the exception. Furthermore, imbalances should not lead to current account crisis, the way they did in the past, when fixed exchange rates prevailed (**Figures 1 & 2**). To be sure, external positions might look unsustainable at times, making adjustment in key variables unavoidable. But in a world of highly flexible and sophisticated international financial markets, such a perceived unsustainability should lead to smooth rather than abrupt and disruptive adjustments in exchange rates.

Figure 1. **Widening imbalances across the main geographic areas...**

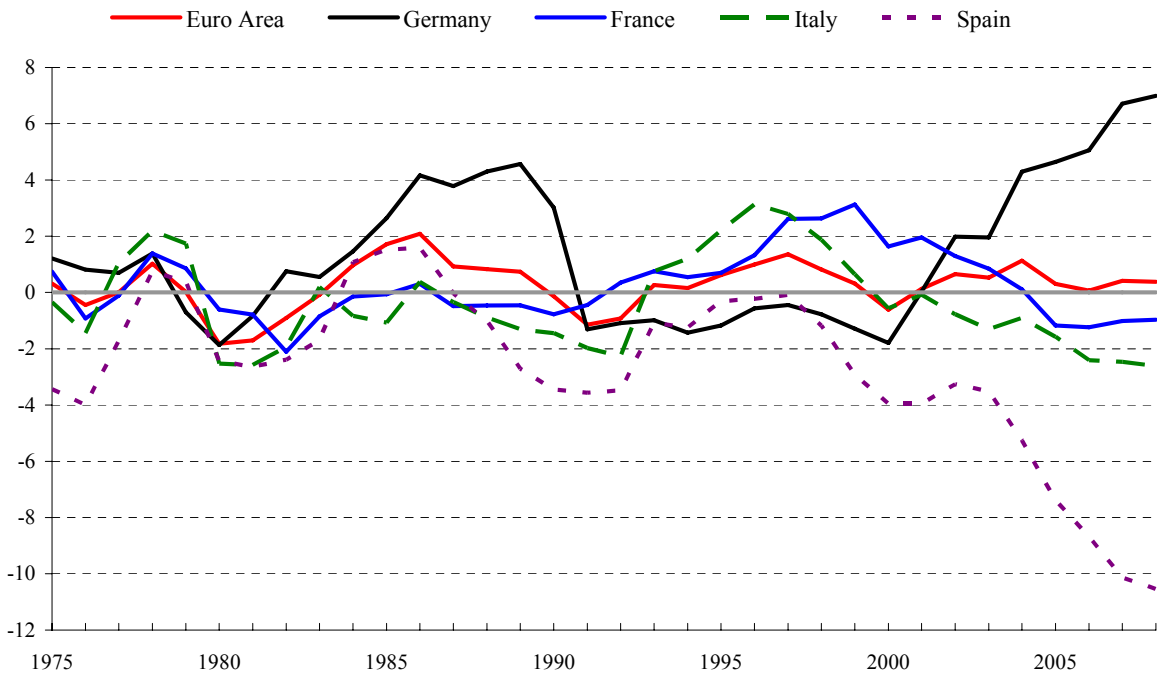
Current account imbalances across the main geographic areas
as a percentage of GDP



Source: OECD Economic Outlook 81 database, IMF World Economic Outlook.

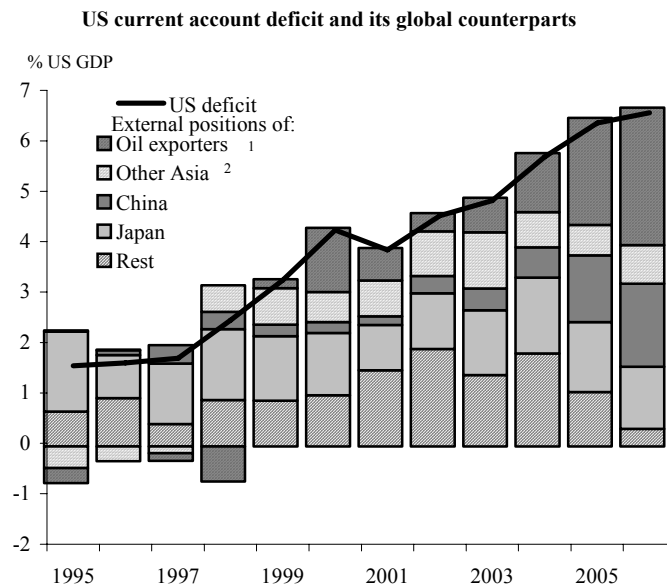
Figure 2. **...as well as within the euro area**

Current account imbalances within the euro area
as a percentage of GDP



Note: Data for Germany prior to 1991 refer to Western Germany.
Source: OECD Economic Outlook 81 database.

Figure 3.



1. Africa and Middle East, Central and Eastern Europe.
 2. Non OECD Asia and Oceania, excluding China and the Middle East.
 Source: OECD Economic Outlook 80 database, International Monetary Fund.

Why, then, worry about current account imbalances? We worry, I guess, because, in practice, imbalances may be reflecting market and policy imperfections. Imperfections that may take the form of self-fulfilling pricing in foreign exchange markets or public policy interferences, stemming for instance from large official financing of the US current account deficit. This official financing, coming most often from Asian public institutions, is intended to constrain exchange rate flexibility. By interfering with market mechanisms, it may thus unleash future disorders of large magnitude.

In practice, we have very little capacity to detect which degree of current account imbalance would lead to an abrupt and costly turnaround. In OECD's most recent projections, published last week, US imbalances are stabilising at 6% of GDP over the period 2007-2008, while Japan's surplus would increase markedly and China's surplus would surpass 10% of GDP. This forecast features very large imbalances. But it did not send tremors through the market.

It may well be the case indeed that, given the ongoing process of financial globalisation and asset diversification, such a US deficit could be absorbed without increasing the share of US assets into world portfolios. This is indeed what our long-term projections suggest. Such a scenario would still be unsustainable, however, in a long-term perspective, because the share of US GDP into world GDP will markedly fall over the next two decades, casting doubts on US ability to repay its external debt.

All in all, policy-makers are trying to avoid what boils down to a low probability event of high economic cost. We know the present current account constellation is not sustainable. But we have little capacity to assess, in real time, the risk of costly unwinding.

Given our lack of knowledge, economic policies that would only target current account imbalances would have quite uncertain benefits. In such a context, remedial policies need to have benefits of a broader nature that extend well beyond current accounts.

Reducing, for instance, US fiscal deficits would be good for the US economy while easing external imbalances. There would be no basis, however, for asking a country to run bad domestic policies for the sake of the global good. I do not think, for instance, that anyone would advise Japan to increase its hitherto unsustainable fiscal deficits for the sake of curing world current account imbalances.

Provided it fits with domestic interest, pre-emptive policy action may be useful. It may increase the probability that any adjustment of exchange rates will occur in a gradual and orderly manner. A widely held view among policy circles, which was re-iterated by the IMFC last month, is that such orderly unwinding of global imbalances requires, for instance, fiscal consolidation in the US and higher investment and greater exchange rate flexibility in emerging Asia.

Are external imbalances an appropriate target for structural policies?

The same overall philosophy applies to structural reforms. They should first enhance domestic welfare through higher potential growth and greater resilience to shocks but they may also contribute to reducing current account imbalances. This is indeed why the IMFC is recommending them for Europe and Japan. But again a good structural policy that contributes to worsen imbalances should not be vetoed.

To give a concrete example, it may well be that successful labour market reforms in Europe would end up increasing its competitiveness and so worsen the US current account deficit. Still, labour market reforms are necessary in Europe and, from a normative perspective, good domestic reforms should be welcomed, irrespective of their impact on current accounts.

Moving now from a normative to a positive perspective, it is interesting to find out in which circumstances good structural reforms would also contribute to reducing current account imbalances

Addressing the issue from a very long-term viewpoint, there seems to be no link between growth and current account imbalances. In the long run, higher potential growth *per se* does not necessarily weaken the current account. This is obvious. Otherwise, rich countries would have had persistent current account deficits and poor countries, persistent surpluses. This would be inconsistent with most existing evidence.

In the short-term, of course, domestic demand is driving growth, which tends to impact the current account through the import side. But in the long-run we are mainly talking about supply-driven growth. At this horizon, higher potential output should entail not only stronger imports but also higher exports. One avenue for higher potential exports was explored some time ago, by Paul Krugman.¹ Fast-growing countries tend to produce a greater number of new varieties of goods

1. Krugman P. (1989), "Differences in income elasticities and trends in real exchange rates", *European Economic Review* Vol. 33, No. 5. Support for Krugman's supply effect based on US import and export data by country is found by Gagnon J. (2003), "Long-run supply effects and the elasticities approach to trade", *International Finance Discussion Papers* No. 754, Board of Governors of the Federal Reserve System. The

than their trading partners. This in turn results in more favourable income elasticities of exports. At the end of the day, such specialisation effects should therefore offset the negative impact of higher imports on the current account.

In such a context, it appears that only in the short to medium term can structural policies influence current accounts. However, these side-effects are likely to vary greatly across countries as well as across types of reforms. In particular, product and financial market reforms in Europe and Japan could presumably help reduce global imbalances. But labour market reforms are less likely to do so. This is somewhat problematic given that Europe is mainly in need of labour market reforms.

In the short to medium-term, reforms would influence current accounts through a permanent income effect. This channel is potentially quite powerful. Reforms boost permanent income, thus pushing down the household saving rate, especially in Europe where it remains relatively high. At the same time, reforms increase the return on capital, which should boost investment. Declining savings and rising investment are matched by net capital inflows that appreciate the exchange rate and reduce net exports.

Such “demand re-switching” would help reduce current account imbalances. But note that it has to be accompanied by dollar depreciation. The implicit assumption here is simply that a brutal and large depreciation would be avoided

The current account effects of structural reforms likely vary across countries and types of reforms

These are general insights about the current account effects of structural reforms. Let me turn now to more concrete reforms in labour, product and financial markets. Trying to answer the following question: to what extent do such reforms reduce saving and/or increase investment? The more they do so, the more structural reforms in Europe and Japan would contribute to reducing global current account imbalances.

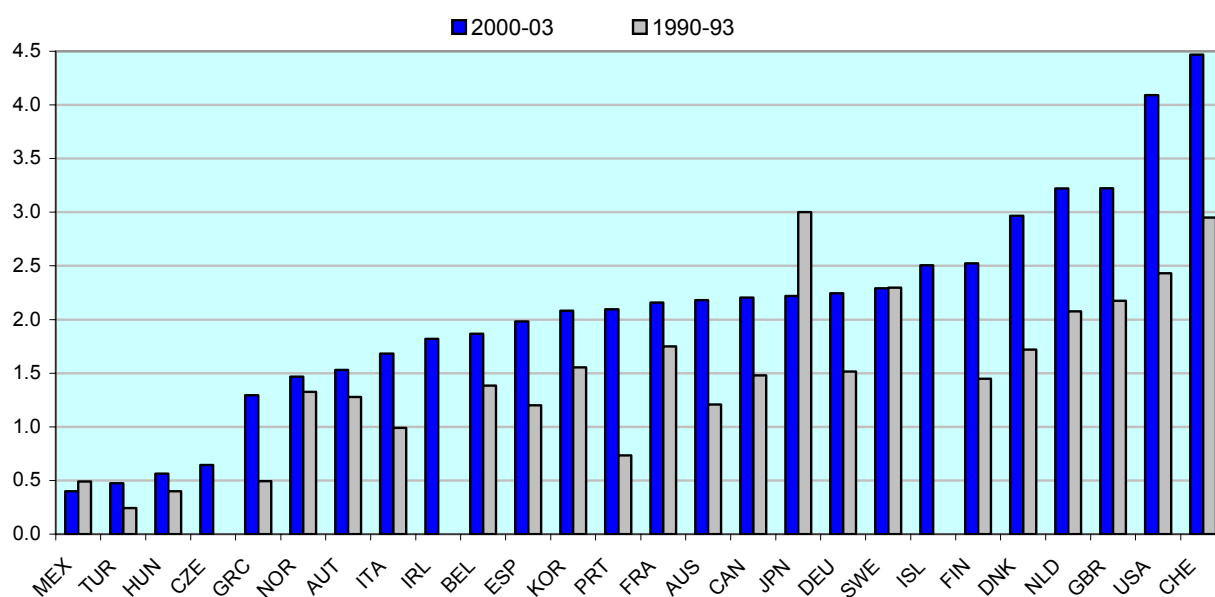
Financial market reform

Let me start with financial market reforms. By virtually any measure, financial markets remain far less developed in Europe and Japan than in the US. For instance, the stock of total loans and securities as a share of GDP is twice as large in the US as in continental European countries and Japan (**Figure 4**). There remains some room for increasing competition in banking and financial services in both the euro area and Japan. Our view is that this could be achieved without jeopardising financial stability.²

cross-country differences in income elasticities of external trade were first highlighted by Houthakker H. and S. Magee (1969), “Income and price elasticities in world trade”, *Review of Economics and Statistics* Vol. 51, No. 2.

2. De Serres A. et al. (2006), “Regulation of financial systems and economic growth”, OECD Economics Department Working Paper No. 506.

Figure 4. **Financial markets remain far less developed in euro area countries and Japan than in the US**
Total loans to private sector and securities capitalisation as a ratio of GDP



Source : World Bank financial structure database.

Intensified competition in Europe and Japan would likely boost investment and reduce saving. On the investment side, OECD panel regression analysis finds a significant positive impact of financial market size on investment.³ On the saving side, more competitive and more complete financial markets would help lift household credit constraints. This would boost consumption and lower saving.

Ultimately, more competition in financial markets would thus weaken current accounts in Europe and Japan. This view is tentatively supported by recent OECD panel regression work, which found that financial market size has a negative impact on the current account balance.⁴

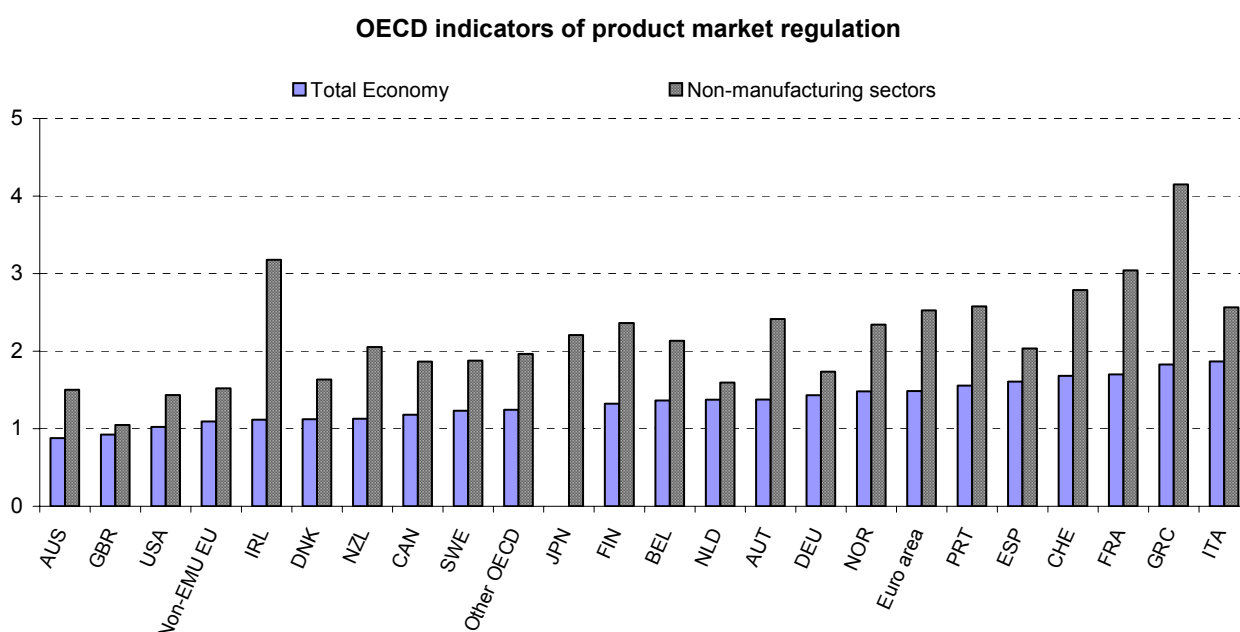
Product market reform

Let me turn now to product market reforms. Despite undeniable progress, product market regulation remains more pervasive in the euro area and Japan than in the US (**Figure 5**).

3. OECD (2003), Sources of Economic Growth, Paris.

4. Kennedy M. and T. Sløk (2005), "Are structural reforms the answer to global current account imbalances?", OECD Economic Studies, No. 41.

Figure 5. Product market regulation remains more stringent in large euro area countries and Japan than in the US



Source: Conway P. and Nicoletti G. (2006), "Product market regulation in the non-manufacturing sectors of OECD countries: measurement and highlights", OECD Economics Department Working Paper No. 530.

Greater product market competition would stimulate firm entry and investment. On the saving side, product market deregulation would increase permanent income, while current income would be unaffected in the short run. This should lead to a decline in the household saving rate.

However, such decline in the saving rate should not be taken as granted. It requires an institutional framework in which permanent income gains can be brought forward.

Higher permanent income associated with product market reforms would bring about higher asset prices. But the smaller the share of financial assets in households' portfolios, the smaller financial "wealth effects" on consumption.⁵ In the same vein, the tighter the credit constraints, the smaller the opportunities for households to borrow against future income.

In the US, wealth effects are strong and credit constraints low. This helps explain why the pick-up in productivity growth since the mid-1990s has been associated with a sharp decline in the household saving rate. By contrast, in the euro area wealth effects are smaller and credit constraints tighter. It is therefore unclear whether a similar pick-up in productivity growth would bring about a consumption boom and a decline in household saving.

5. Catte P., N. Girouard, R. Price and C. André (2004), "Housing markets, wealth and the business cycle", OECD Economics Department Working Paper No. 394. Likewise, recent OECD work has found that housing wealth effects are larger where financial markets provide easy access to mortgage financing and to financial products that facilitate house equity withdrawal.

This brings us back to the need for financial market reforms in the euro area and Japan. These would help reduce imbalances not only directly, but also indirectly by magnifying the current account effects of product market reforms.

One last point on product market reforms. Maurice Obstfeld and Ken Rogoff have argued that reforms concentrated in the traded goods sector may well *improve* – rather than deteriorate – the current account position.⁶ The main thrust of their argument is that such reforms may well boost the production of tradables more than its consumption. Since the trade balance is the difference between the production and consumption of tradables, surplus should rise.

In other words, the more product market reforms are concentrated on the non-traded sector, the more they are likely to weaken the current account. This is good news since product market reform in the euro area and Japan needs to be focused on the services sector (**Figure 5**).

Labour market reform

I have more doubts about whether labour market reforms would help reduce current account imbalances. At first glance, they increase permanent income and should therefore reduce the household saving rate. Just like other reforms. But in the short run, this effect may be more than offset by an increase in precautionary saving. Think for instance about the German experience with labour market reform: household confidence fell sharply initially, and it took years for it to recover.

Indeed, cutting unemployment benefits reduces households' income in the short run. Reducing the stringency of employment protection legislation creates uncertainty among the so-called "insiders". In addition, workers are less likely to perceive the long-term gains of these reforms in terms of lower unemployment and higher job creation.

So while labour market reforms are urgently needed in large euro area countries, they may not do much to ease current account imbalances.

All in all, it appears that structural reforms would, most often, impact the savings/investment balance in a transitory way. Structural reforms obviously have lasting effects on aggregate supply but they need not induce a lasting, structural "improvement" in the savings/investment balance. If the objective is to permanently switch back external balances to a different and maybe more appropriate level, policy instruments should then be selected for their lasting impact on the target of choice. In this respect, appropriate exchange rate settings and fiscal policies look better suited for the task at hand.

Concluding remarks

Let me conclude. Achieving an orderly unwinding of current global imbalances will not be easy. And in any event, many prominent researchers – using a variety of approaches – have

6. Obstfeld M. and K. Rogoff (2004), "The unsustainable US current account position revisited", NBER Working Paper No. 10869.

argued that a sizeable depreciation of the dollar is likely to occur.⁷ So from a policy perspective, the real challenge is more to avoid the kind of abrupt and large fall that would send the world economy in turmoil.

Fiscal policy retrenchment in the US certainly offers a first-best policy option, since it is desirable in its own right. In Europe and Japan, such first-best policy instruments are unfortunately unavailable. Structural reforms therefore seem to offer a straightforward second-best option. All the more so as they are needed anyway in order to boost economic growth.

I have argued that financial market reforms and product market reforms in services would probably help reduce current account imbalances. This is less obvious for labour market reforms, even though these are what the euro area needs most.

Let me finish by pointing out another related benefit of structural reforms. They would help the euro area and Japan buffer the negative economic impact of an abrupt fall in the dollar, should it finally occur. This is because reforms would make the European and Japanese economies more resilient to adverse shocks. In particular, they would allow a swifter reallocation of labour and capital towards non-tradable goods, mainly services. I would also argue that reforms would make a fall in the dollar more acceptable from a political standpoint, because Europe and Japan would have a higher growth rate to start with.

7. See in particular: Blanchard O. F. Giavazzi and F. Sa (2005), "International investors, the US current account and the dollar", *Brookings Papers on Economic Activity* 2005:1; Caballero R., E. Farhi and P.O. Gourinchas (2005), "An equilibrium model of "global imbalances" and low interest rates", NBER Working Paper No. 11996; Obstfeld M. and K. Rogoff (2004), *op cit*.