



# **Current Global Financial Imbalances are Unsustainable**

**Clemens Kool**  
professor of Finance and Financial Markets

**Eurobanking**

**May 18, 2010**



## Overview

- Introduction
- Economic and financial Integration since early 1990s
- Global imbalances: current account and net foreign assets
- Sustainability issues
- The European problem: North vs South
- Adjustment problems
- Conclusion

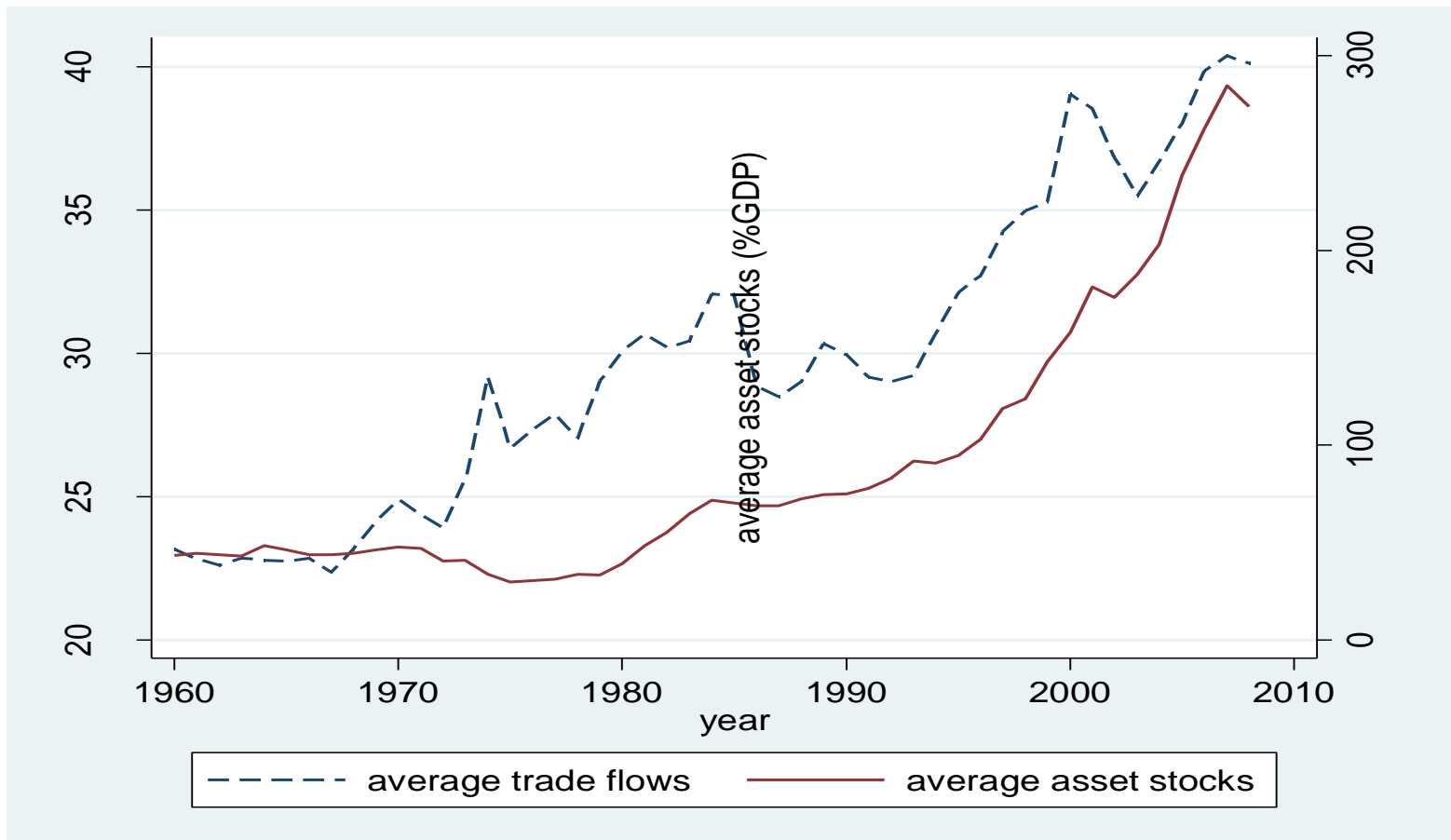


## 1. Introduction

- On-going financial integration, especially since mid 1990s
  - ☑ Higher gross foreign assets (equity, FDI, debt)
  - ☑ Higher gross foreign liabilities (equity, FDI, debt)
  - ☑ Higher net foreign assets
- Generally seen as an achievement:
  - ☑ Better allocation of capital
  - ☑ Better risk sharing



## Growth in economic and financial integration



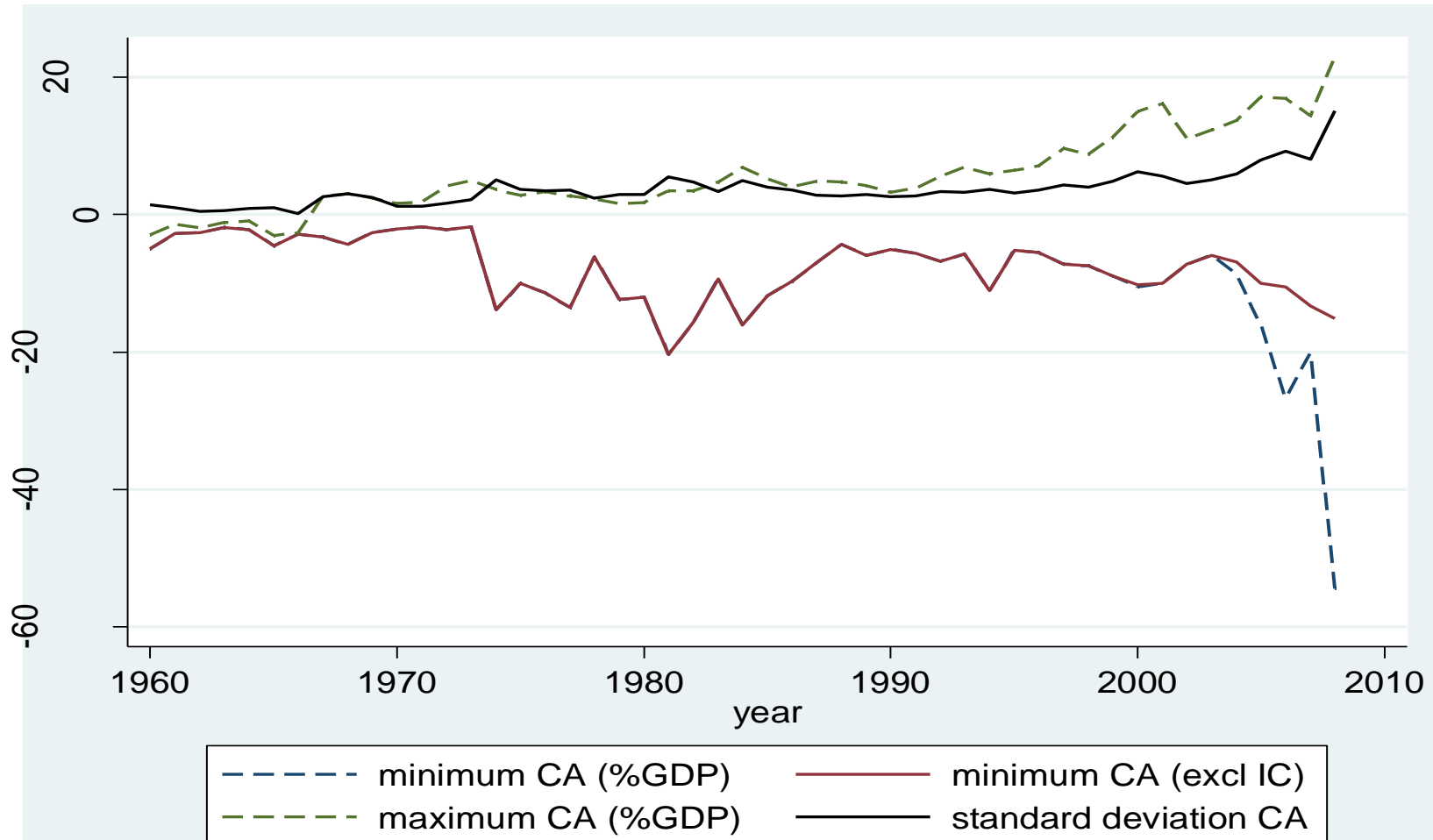


## 2. Overview of global imbalances

- Financial (and economic) integration allows easier current account imbalances
  - ☑ Balance of Payments (BoP) = Current Account (CA) + Financial Account (K) = 0
  - ☑  $K = -NFA$  (net foreign assets)
- The size and volatility of CA (and K) imbalances strongly increases since early 1990s
  - ☑ Flow issue
- The size and volatility of cumulative CA (and K) imbalances increase over time?
  - ☑ Stock issue (net foreign asset or wealth)
  - ☑ Potential role for valuation gains

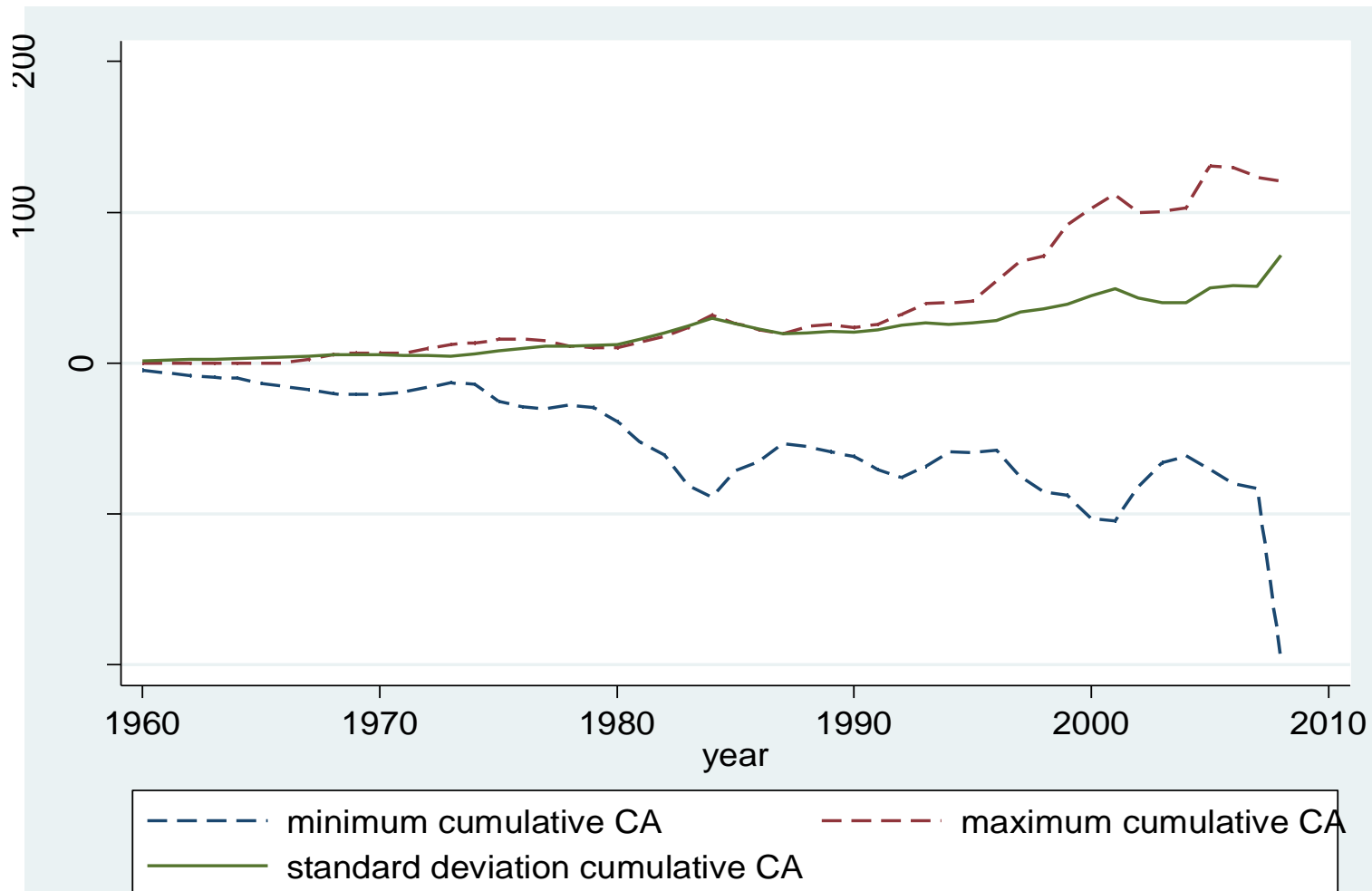


## Current account imbalances



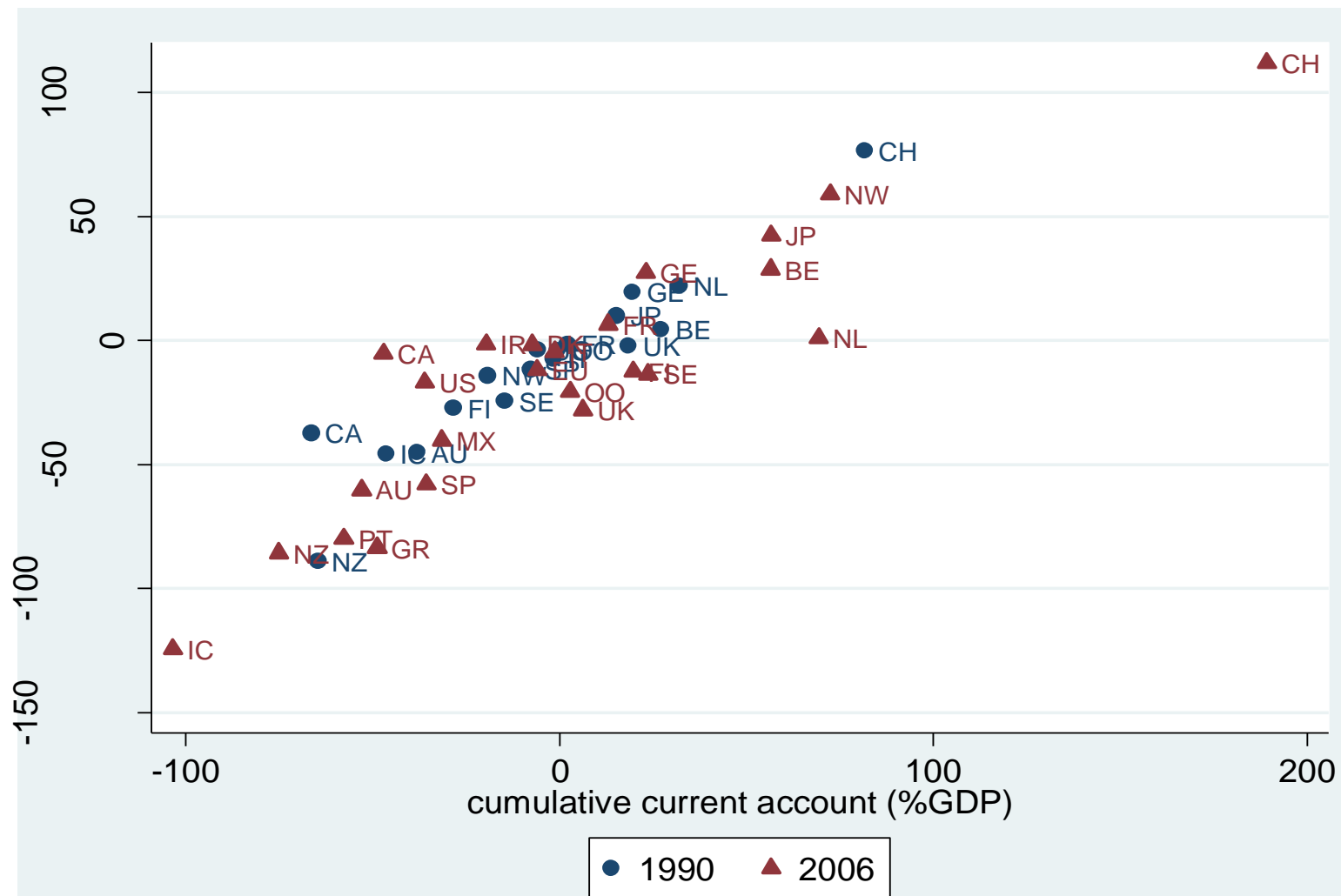


## Cumulative current account imbalances





## Net foreign asset development per country 1990-2006





## 3. Sustainability issues

- Very little discussion about global (BoP) imbalances until very recently (apart from US case): unwarranted
  - ☑ Net foreign asset ratio cannot grow without bounds
    - unsustainable level is unclear
  - ☑ Adjustment process is unclear and potentially painful
    - Financial markets fail to charge high real interest rates and real fx depreciations to deficit countries
  - ☑ Factors raising fragility/unsustainability
    - High level of debt-like foreign liabilities (noncontingent claims)
    - High leverage (foreign assets equity type, foreign liabilities debt-like)
    - Liabilities denominated in foreign currency
    - Fixed exchange rate regime (speculative attacks)



## Countries with sustainability problems

- Iceland (crisis has occurred)
- Australia and New Zealand
  - ☑ Negative net wealth (-), but flexible exchange rate (+) and relatively low debt funding (+)
- United States
  - ☑ Relative position not too bad but...
  - ☑ Absolute size + reserve currency role make it a rest of the world problem: real dollar depreciation leads to macro costs concentrated in rest of the world
- Southern-European members of euro area
  - ☑ Negative net wealth, high debt funding, lack of adjustment
  - ☑ Incorrect assumption that BoP problems in currency union play no role

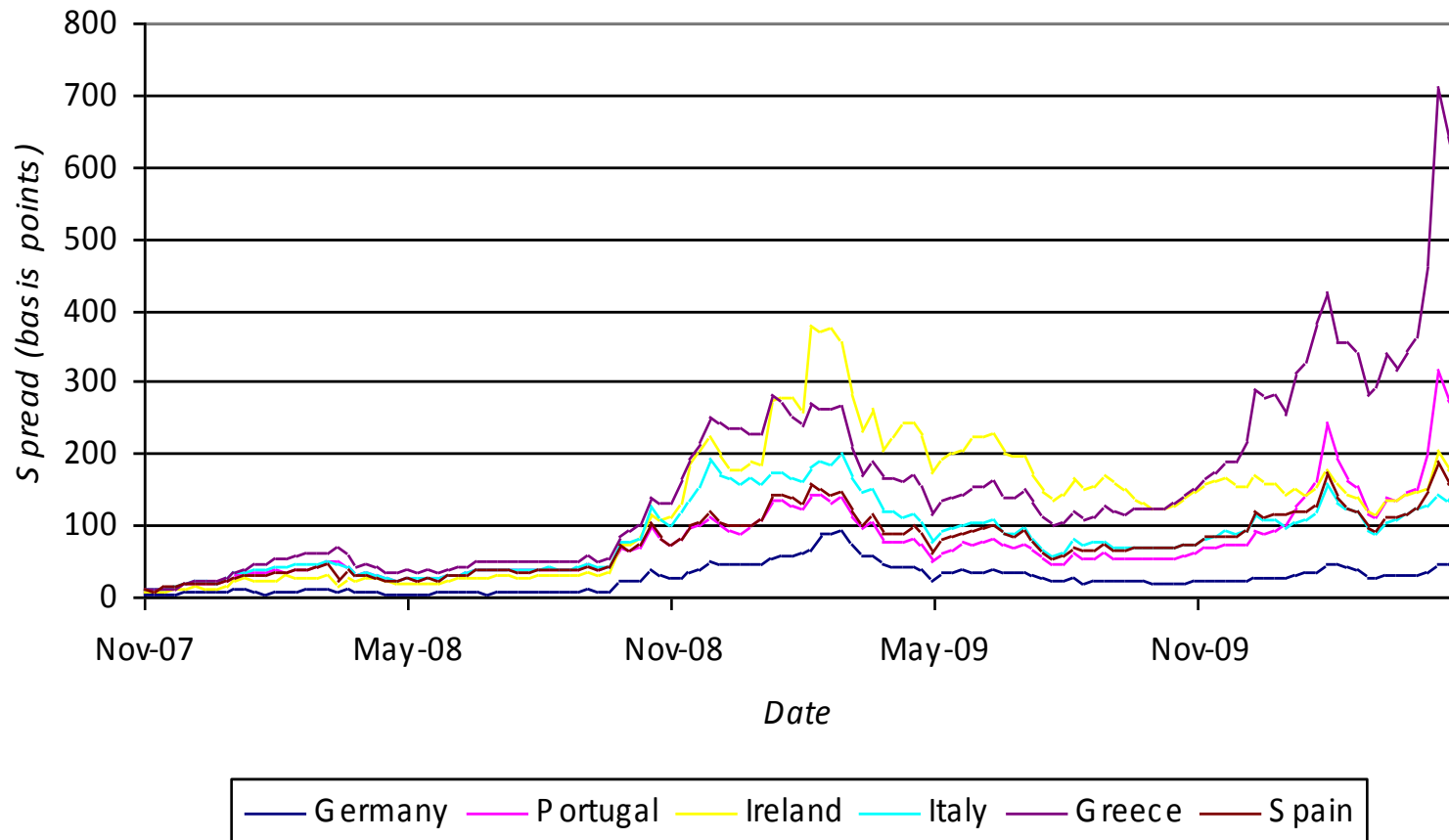


## 4. The European Problem: North vs South

- Growing structural macro imbalances in euro area
  - Euro area as a whole more or less balanced CA
  - Public vs private behaviour
  - Lack of functioning adjustment mechanisms
- Lack of (political) attention till late 2009!
- Stylized facts
  - North (GE, NL, AU, FI) vs South (GR, ES, PT, IR)
    - Including Italy with South makes no difference

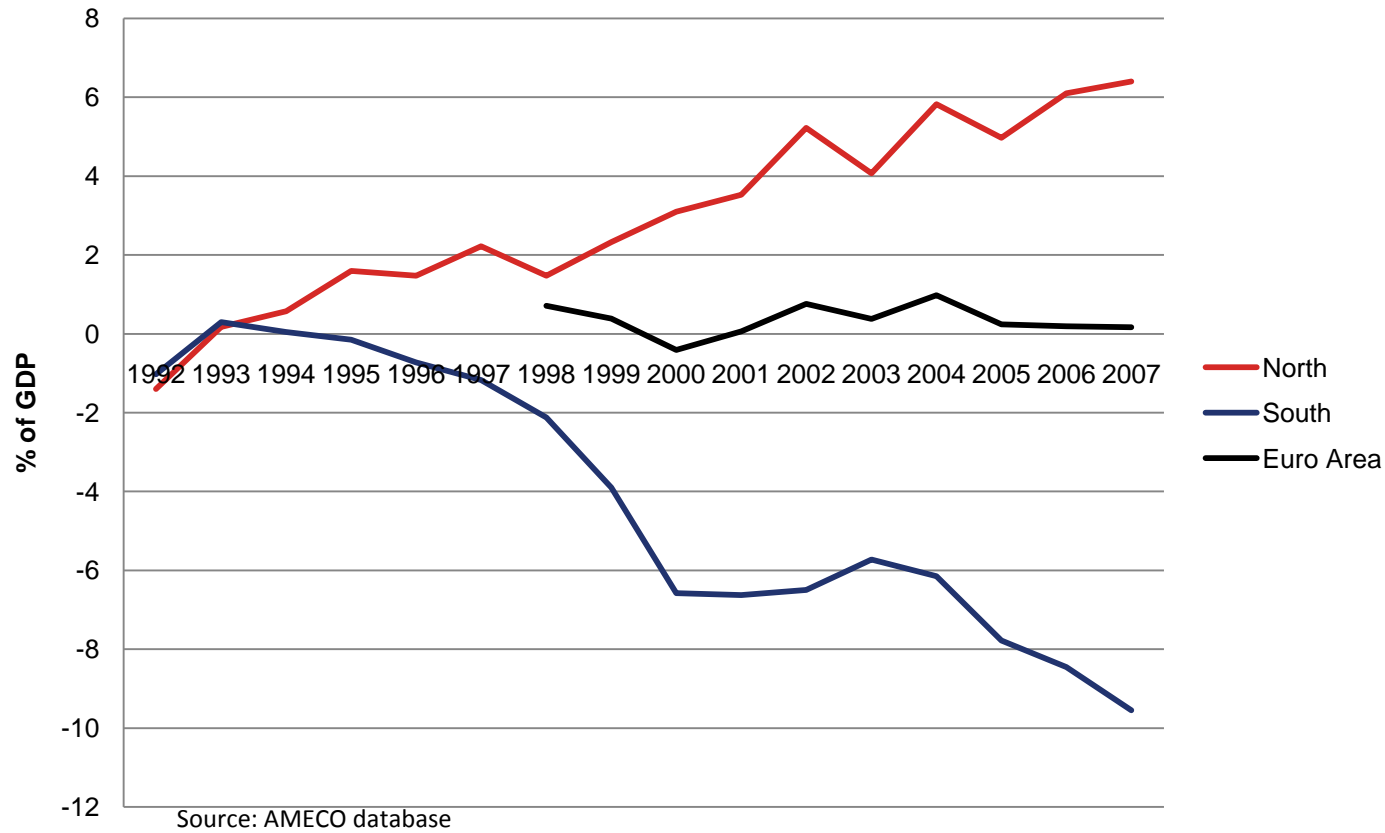


### CDS Spread (5-year)



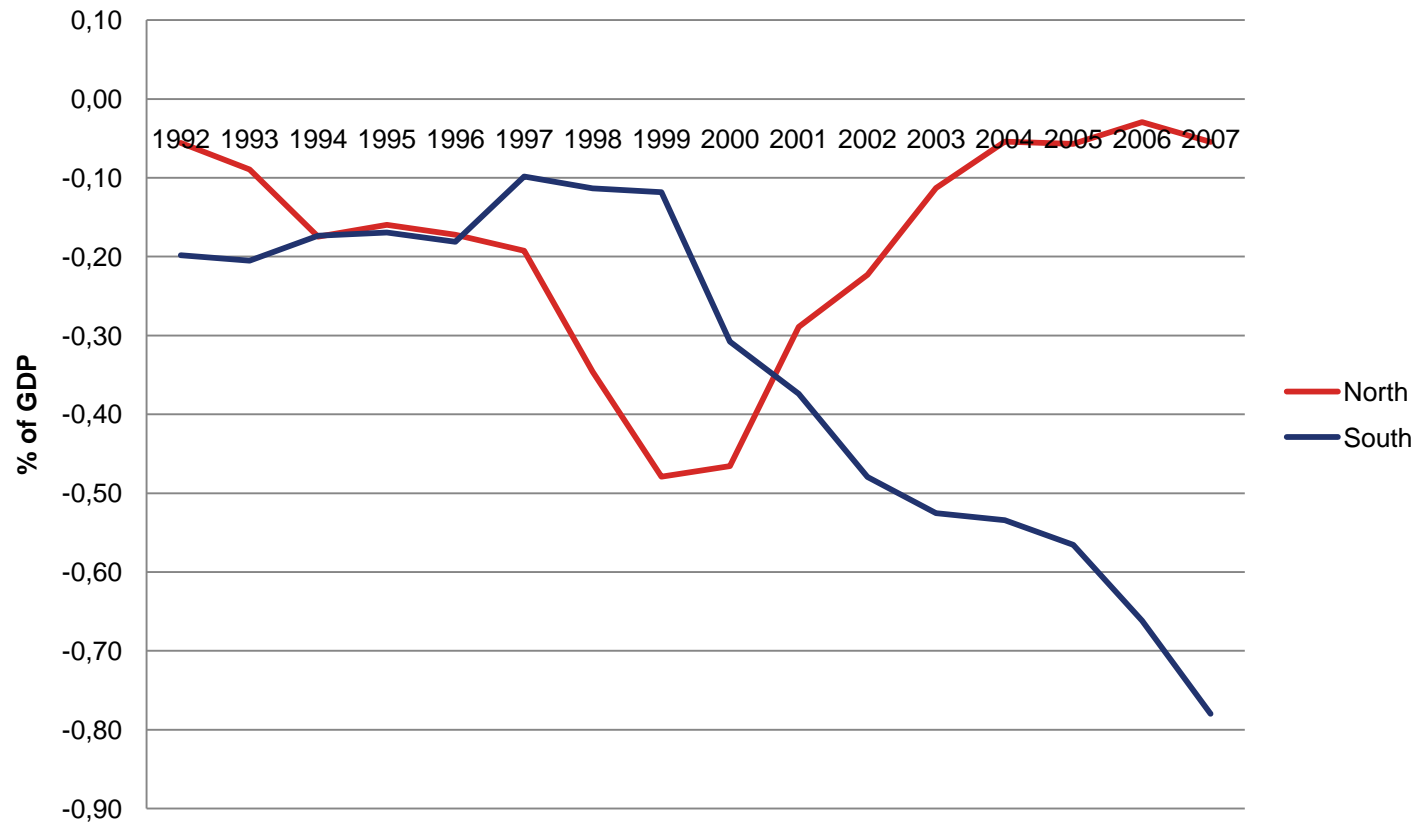


## Current account (% of GDP), 1992-2007





## Net foreign assets (% of GDP), 1992-2007



Source: Lane and Milesi-Ferretti (2007)

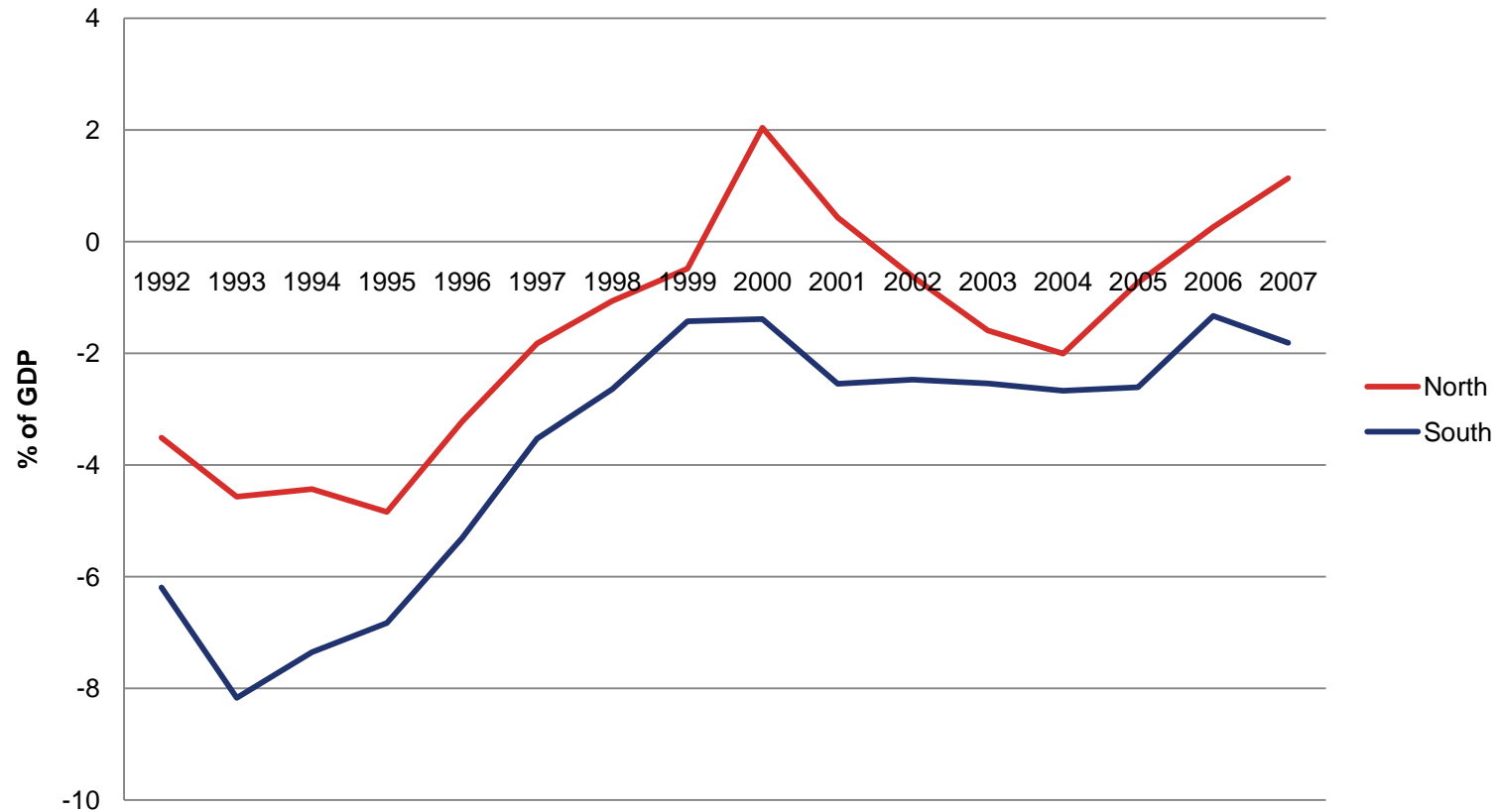


## External finance in South: summary

- Net external debt of South has strong increasing trend since 1999
- Composition of current account shows that
  - Trade balance is relatively stable (no adjustment through real exchange rate or wealth effects as yet) at -3% for South
  - Net factor income in South is declining (increasing interest payments on the debt) to -5% for South
  - Net transfers to South (from EU) have steadily declined to about zero in 2007
- Result is that both trade deficits (3%) and interest payments (5%) are currently financed by increasing external debt
- Who is borrowing and why?



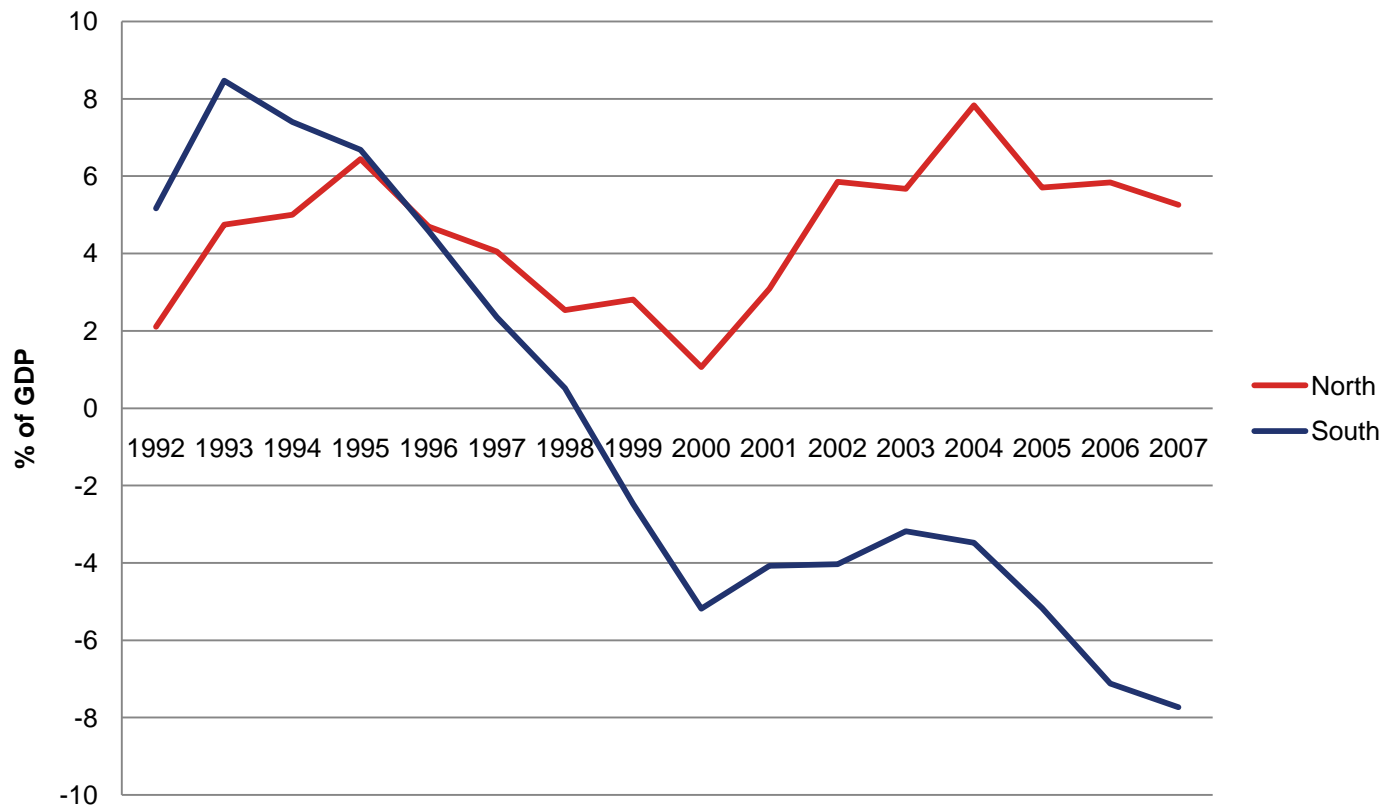
## Public net savings (% of GDP), 1992-2007



Source: AMECO database



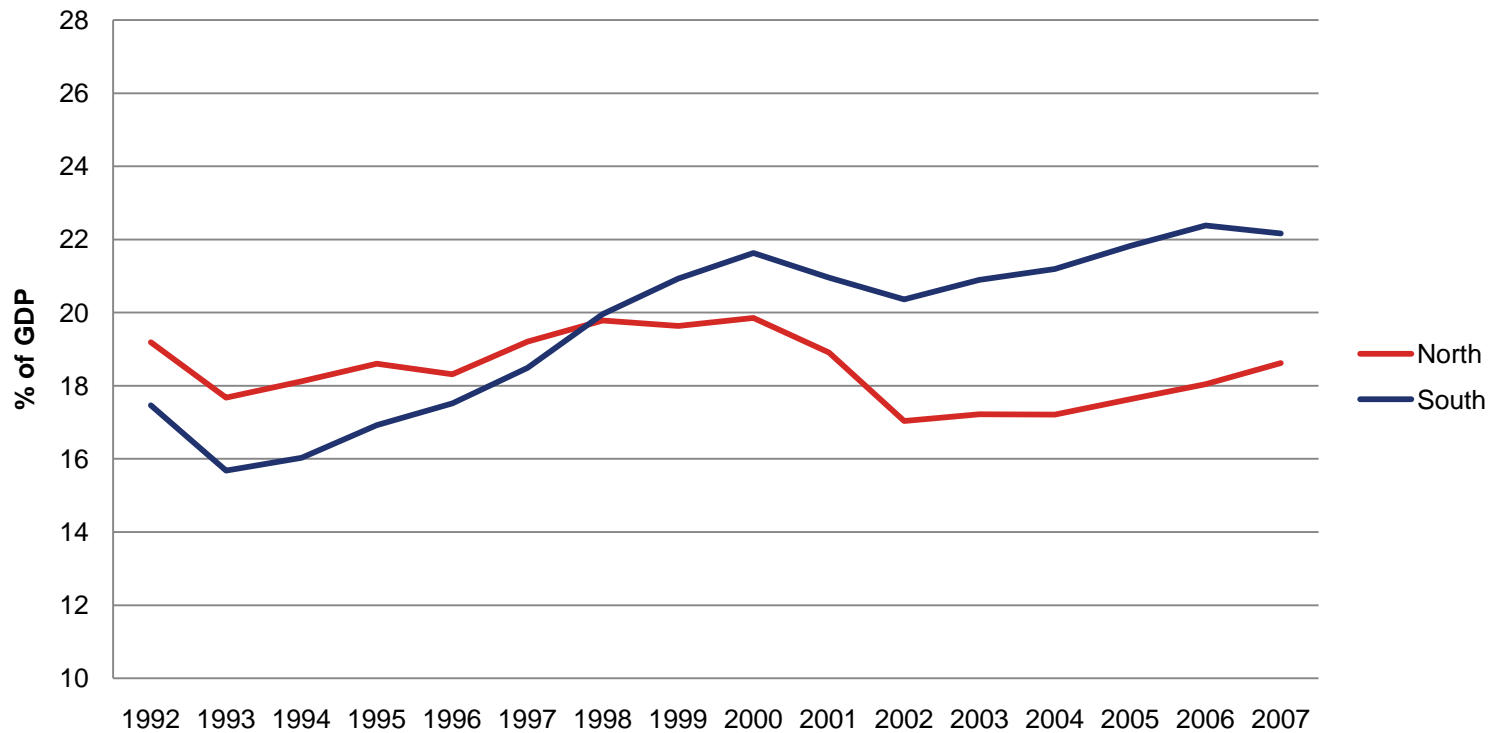
## Private net savings (% of GDP), 1992-2007



Source: AMECO database



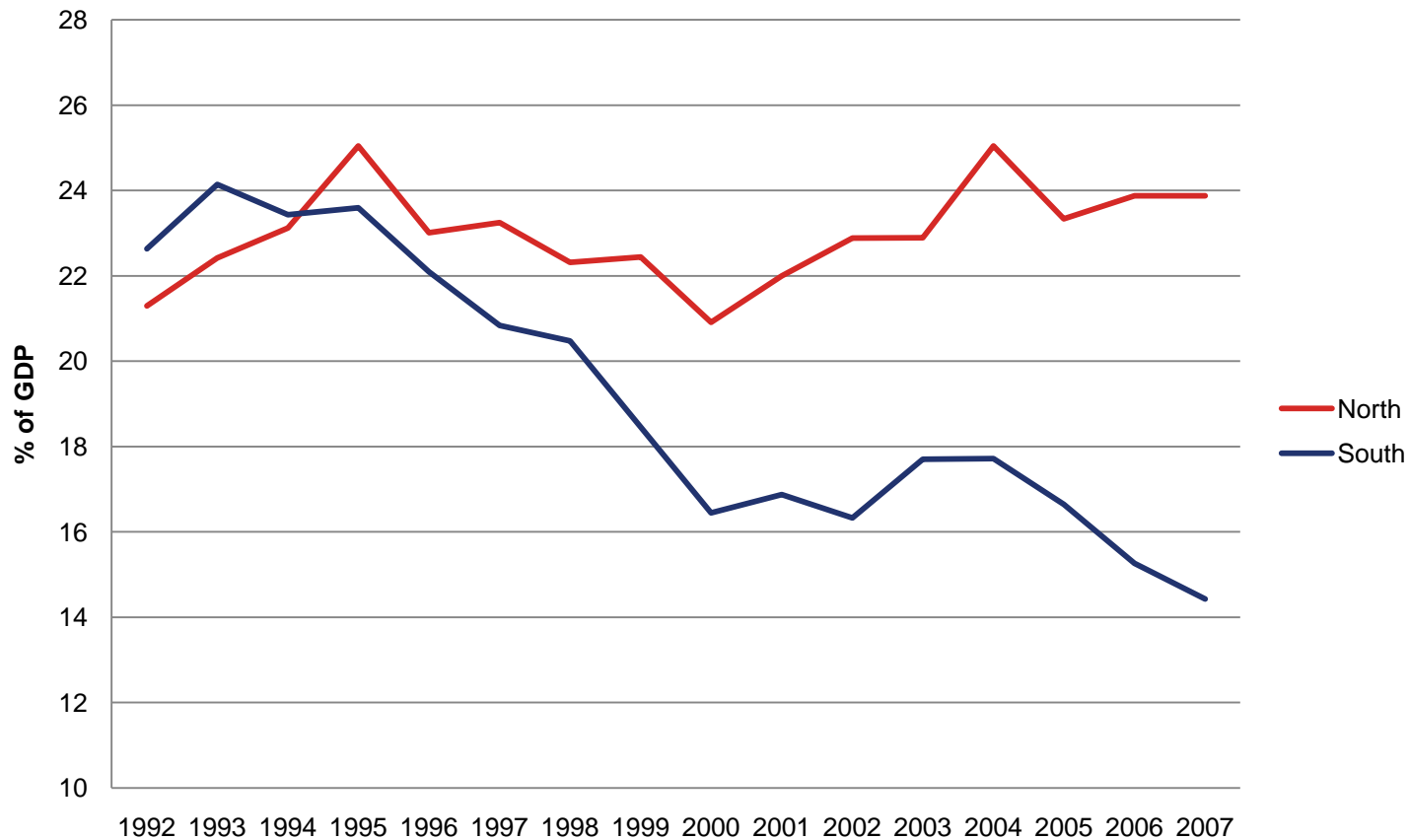
## Private investment (% of GDP), 1992-2007



Source: AMECO database



## Private savings (% of GDP), 1992-2007



Source: AMECO database



## Composition CA imbalances (%GDP)

	Current Account		Net Public Savings		Net Private Savings	
	92-98	99-07	92-98	99-07	92-98	99-07
<b>South</b>	-0.7	-6.8	-5.7	-2.1	5.0	-4.7
<b>North</b>	0.9	4.6	-3.3	-0.2	4.2	4.8



## Who is borrowing why in the South?

- Imbalances since 1999 largely due to deteriorating net private savings
  - In 2<sup>nd</sup> subperiod, gap is 9.5%
- Public savings stabilize at -2% (South) – not adjusted for business cycle
- Only small part of the private net savings gap is due to higher investment in South (about 3%)
  - Consistent with capital flowing there because of higher marginal returns
- Most of the private net savings gap comes from strongly declining gross savings in South (6.5%)
  - This implies excessive (private) consumption (real estate booms) in South

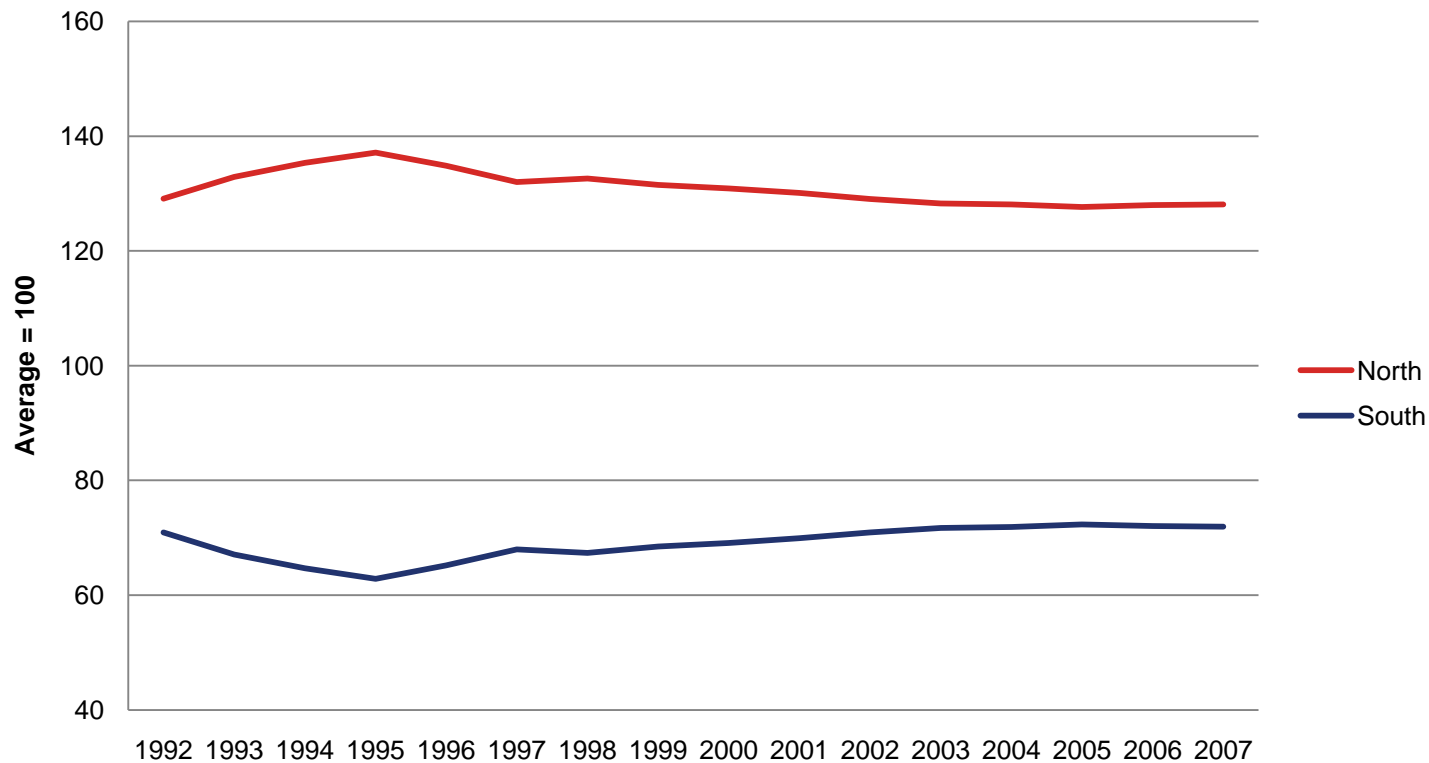


## Is there hope for repayment?

- South has lower per capita income and lower productivity than North, so capital should flow from North to South during the adjustment period leading to higher investment and higher capital (with which high external debt can be repaid ultimately) as well as higher consumption (given forward-looking expectations of higher future income)
- In the same adjustment process, (relative) inflation is likely to rise in South, leading to real exchange rate appreciation and loss of competitiveness (higher terms of trade). As a result, a current account deficit arises matching the capital surplus
- Overall, convergence would be expected to take place



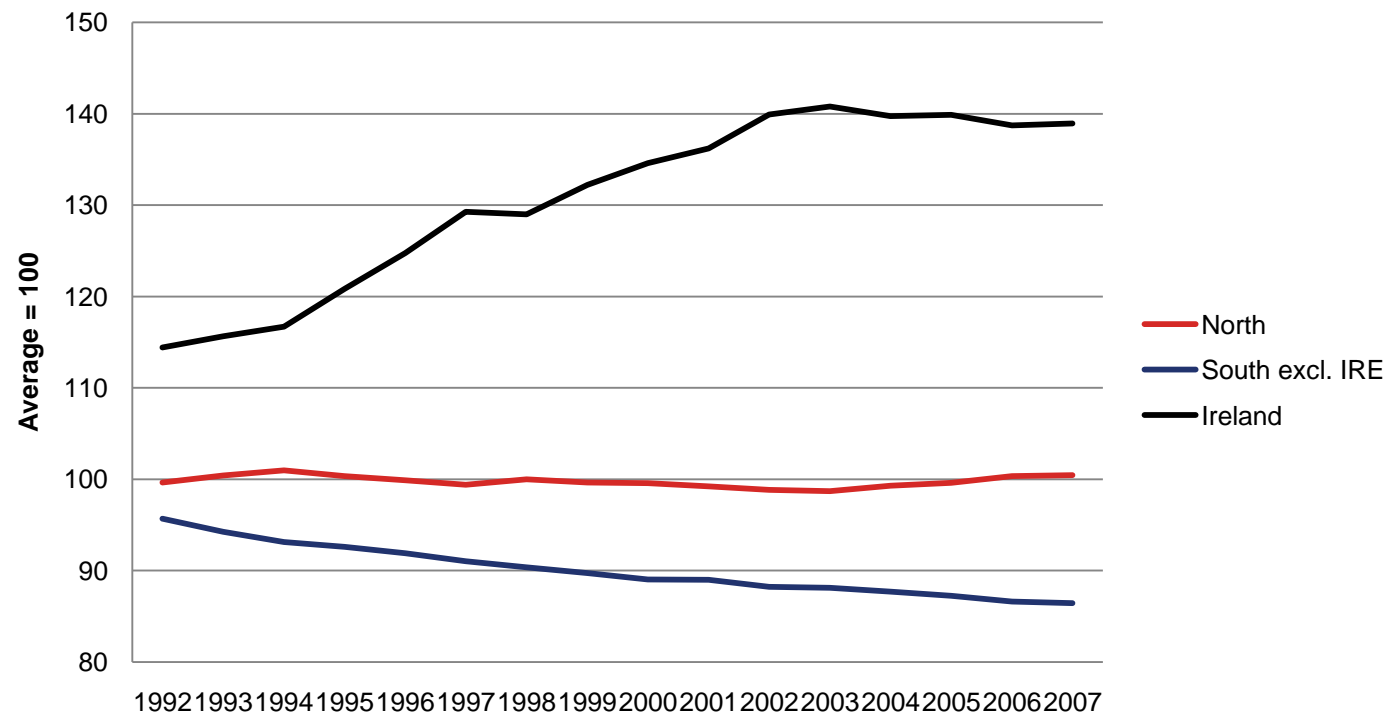
## Relative real GDP per capita (average = 100), 1992-2007



Source: AMECO database



## Relative total factor productivity (average = 100), 1992-2007



Source: AMECO database



## Validity of convergence hypothesis

- At this point, convergence appears not very strong (with Ireland the exception)
- Productivity and per capita income do not appear to rise
  - Concerns about repayment are justified



## 5. Adjustment problems

- Currently, pressure is on public sector in the South to reduce deficits
  - Necessary, but insufficient
  - Private sector is part of the problem and needs to become more productive; foreign debt in some countries is more private (banks) than public
  - Note that private debt can easily become public debt (Iceland had virtually no public debt before the bank defaults)
- Higher real interest rates for the South need to be charged
  - Currently high risk premiums help; relatively high inflation because of convergence path is complicating factor
- Real depreciation is needed
  - Even more problematic with common currency and relatively high inflation: requires cuts in labour costs in private sector



## 6. Conclusion

- Well-developed, open and stable global financial system must be maintained
- Negative side-effect is excessive buildup of global imbalances (in gross and net asset and liability stocks)
  - ☑ Financial markets fail to timely price in risks to correct excesses
- Focus on public sector (sovereign debt crisis) is too narrow-minded
  - ☑ In addition we should seriously look at the private sector's (foreign) debt that could easily lead to banking and/or BoP crisis
- Especially in common currency area (euro zone) there is a lack of adjustment mechanisms which complicates the problems
  - ☑ Stricter SGP and more policy coordination appears only way out