



BANK OF ENGLAND

Speech

Rebalancing

Speech given by

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Good morning! It is almost six years since the onset of the Global Financial Crisis and almost four years on from the trough of the recession that followed the collapse of Lehman's. Yet despite highly stimulatory monetary policies, we are still a long way short of seeing a full recovery in the advanced economies. Here, output remains some 2½% below its pre-crisis peak, while in the euro area the shortfall is even larger at 3¼%. And even in the United States, where the recovery is further advanced, output is just 3¼% above its pre-crisis peak, well below where one might have expected on the basis of past cyclical recoveries.

That sluggishness in the recovery reflects the fact that, unlike a normal cycle, substantial real adjustments are also required in our economies. These include not only the repair of over-extended balance sheets, especially in the banking sector, but also the need to shift the composition of demand and production towards more sustainable patterns. And these shifts require changes not only in the indebted countries, but also corresponding shifts in the pattern of demand and production in other countries. To what extent are these changes under way?

Let me begin with our own rebalancing challenge, here in the United Kingdom. The pre-crisis decade was generally one of steady growth and inflation close to the target, and thus few signs of overheating in the real economy. Domestic demand nevertheless consistently outstripped the supply of output, generating a small but persistent current account deficit, averaging around 2% of GDP. MPC members noted on several occasions that this would have to be corrected at some stage, and would most probably need to be accompanied by a lower sterling real effective exchange rate.¹

Such a rebalancing process appeared to have been set in train by the deterioration in the outlook and the rise in uncertainty associated with the financial crisis. Household spending collapsed, as the saving ratio rose from around 1-2% to around 7%, with much of the rise accounted for by the behaviour of highly indebted households (Chart 1); businesses' capital spending also fell sharply, though that is something we would like to have seen more of, rather than less. At the same time, sterling fell by a quarter. That should have given us a head start in crowding in net exports to replace the lost domestic demand. The performance of net exports has, however, been distinctly underwhelming, adding just 1½ percentage points to total growth since the start of the recession. That is not simply a reflection of the weakness in our export markets, as the weakness at home has depressed imports correspondingly. Once one controls for the changes in activity at home and abroad, net exports still look weak.

Imports and exports of goods have, however, behaved pretty much as expected. For example, the decline in our share of the market for exports of goods appears to have been halted (Chart 2). The real disappointment has instead been in exports of services, where our market share – which had been rising strongly before the crisis – has flattened off, rather than accelerating. A large part of that reflects a decline in the demand for financial services globally as a result of the crisis, but that alone is not sufficient to explain the weakness. Along with the surprising robustness of employment, the disappointing performance of net trade is yet

¹ See e.g. Bean (2002) and King (2000, 2006).

another puzzling aspect of this particular downturn. One possibility is that the lags have been elongated, perhaps because heightened uncertainty has inhibited the necessary investment to move into new markets. If that is the case, then net exports can be expected to perform better as recovery here and abroad proceeds. But another possibility is that the demand for, and supply of, exports have become less responsive to relative price signals, perhaps reflecting the nature of the goods and services we have a comparative advantage in. That would imply a less optimistic outlook.

Let me now venture further afield, to the euro area. The euro area is by far our largest trading partner – accounting for getting on for half our exports – and those direct links are supplemented by close financial ties between our domestic banking system and the continent. So it is hardly surprising that recent *Inflation Reports* have singled out developments in the euro area as a key risk to the UK outlook.

Although the euro area has been in rough current account balance since the introduction of the euro, there have of course been substantial intra-zonal imbalances. In the run up to the crisis, periphery countries ran persistent current account deficits financed in large part by borrowing from core countries, especially Germany. As a result, the net international investment position of Spain has deteriorated by around 60% of (annual) GDP since 2000, while for Greece and Portugal the number rises to around three quarters of GDP (Chart 3). On the other side, Germany's net international investment position has improved by around 40% of GDP.

Initially these imbalances were seen as the benign consequence of an underdeveloped periphery catching up with a richer core. But on top of that were less benign influences. First, perceptions of supply potential in the periphery appear to have been over-optimistic; subsequent revisions to the IMF's estimates of spare capacity bear witness to that (Chart 4). Second, credit conditions loosened substantially, supported by a sharp compression in perceived long-term risk-free rates, which was only unwound when markets began re-pricing in the risk of bank and sovereign default in the periphery (Chart 5). The decline in interest rates in the periphery in the pre-crisis period suggests that it was a case of capital being pushed into the periphery, rather than it being sucked in by a high rate of return as conventional analysis would suggest. The consequence of all this was an increase in demand in the periphery, much of it in construction, financed by borrowing from the core.

This is illustrated in the contrasting experiences of Spain and Germany. Domestic demand in Spain consistently outstripped output growth pre-crisis, while the opposite was true in Germany (Chart 6). These growing external imbalances were accompanied by increasing internal imbalances, as the non-tradable sector in Spain expanded at the expense of the tradable sector, driving up unit labour costs in the former relative to the latter (Chart 7). That was not the case in Germany.²

² As productivity tends to rise faster in manufacturing than services, unit labour costs on average rise faster in non-tradables than tradables. But, as Chart 7 makes clear, the gap was much greater in Spain than Germany.

Restoring the euro area to strong and balanced growth requires dealing not only with the accumulated financial imbalances – the excessive banking and sovereign debts in the periphery – but also restoring competitiveness and rebalancing the structure of demand and production. On the face of it, that rebalancing is under way, with a narrowing in the current account deficits of the periphery. Chart 8 indicates, however, that much of that is attributable to the substantial fall in imports associated with the collapse in domestic demand, rather than a rise in exports (although to the extent that there was excess demand before the crisis – as Chart 4 suggests – part of that decline in imports will be warranted).

Moreover, the necessary sectoral reallocation of resources is harder to achieve in a currency union than in a country with its own currency, as the exchange rate is not free to adjust to expedite the necessary adjustments in prices and quantities. Absent a supply-side miracle to raise productivity in the periphery, the necessary reversal in the movements in relative unit labour costs needs instead to come about through wage and price adjustment, which may require a sustained period of spare capacity in the periphery together with excess demand in the core.

There is, however, an inherent asymmetry, noted long ago by Keynes, that when credit flows dry up, adjustment is compulsory for the debtor but only voluntary for the creditor. Moreover, not only does the creditor lack the urgent need to adjust, they may also feel that the debtor *ought* to bear more of the burden of adjustment on moral grounds. Consequently the pressure for austerity is greater in the periphery, than it is to boost demand in the core. So, while the euro-area authorities have been making substantial progress in constructing the economic architecture to support the monetary union, the adjustment process taking place in the periphery is nevertheless likely to continue to weigh on euro-area demand prospects for some time. And that will also act as a headwind to the recovery here in the United Kingdom.

Let me turn finally to the global picture. During the build-up to the financial crisis, significant international payments imbalances emerged (Chart 9). On one side were the advanced economies, most especially the United States, running large and persistent current account deficits. On the other side were the emerging economies – most notably in Asia – and latterly the oil exporters, showing large current account surpluses. In the decade prior to the financial crisis, for example, the US current account deficit widened from under 2% of GDP to 5%, while the surplus in China rose from 4% of GDP to 10%.

That constellation of international payments flows, with emerging economies exporting capital to advanced economies, was the opposite of what conventional economic models would predict. Normally one would expect countries in the catch-up phase of economic development with temporarily high investment levels to import the necessary savings from overseas. But a combination of limited household safety nets and under-developed domestic financial markets generated unusually high private savings rates. In addition, some emerging economy governments engaged in the accumulation of foreign reserves, in order both to sustain export-led development and to insure against sudden capital outflows of the sort seen in 1997-8. So

capital flowed uphill, rather than downhill as in the euro area. Moreover, there was a strong desire to hold these savings in safe assets, such as US Treasuries.

The counterpart to this 'savings glut' was downward pressure on the interest rates on those safe assets in the advanced economies. Faced with these lower returns on safe assets, investors then sought to generate higher returns in other ways, including packaging securities in ways that appeared to combine yield with safety. And a long period of benign economic outcomes – the Great Moderation – lulled investors into a false sense of security. The consequent buoyancy in asset prices and easy availability of credit then helped sustain demand. But all this came to an end when investors realised the true nature of their exposures, leading to a scramble for safety, a drying-up of credit and a sharp reduction in spending by households and businesses.

This analysis focuses on the *net* capital flows between countries, but in passing it is worth noting that *gross* capital flows can be just as, if not more, important.³ The pre-crisis leveraged search for yield resulted in an unprecedented expansion of debt within and across countries' financial systems (Chart 10). Much of this 'banking glut'⁴ can be traced to the advanced economies: for example, around half of the gross inflows into the United States just before the crisis came from European institutions, rather than emerging economies.⁵

Now global capital flows of this nature can be valuable. They help to oil the wheels of the international financial system, allowing saving to flow to where it can be most effectively used. They allow banks to diversify across national boundaries, reducing their susceptibility to idiosyncratic domestic shocks. And they increase the degree of competition within the domestic banking market. But by increasing the linkages between financial systems, they can also increase systemic vulnerabilities. In this case, banks became dependent on short-term funding from overseas, rather than their traditional domestic deposit base. When investors re-trenched, that funding dried up and banks struggled to find viable alternative sources of funding. Ensuring gross capital flows are not excessive is just as important as avoiding excessive net capital flows.

Moving to a sustainable equilibrium requires a narrowing in the international payments imbalances. And we have indeed seen such a narrowing since the start of the crisis. For instance, the International Monetary Fund (IMF) expects a current account deficit in the United States of just under 3% of GDP this year, while the Chinese surplus is expected to have fallen to around 2½% of GDP. But, as with the euro area, the crucial question is how much of this narrowing is simply a reflection of the cyclical weakness in the deficit economies or whether it represents a more durable shift in the pattern of demand in both deficit and surplus economies. If it is down to the former, then the imbalances can be expected to re-emerge as recovery proceeds.

³ See Borio and Disyatat (2011), Cecchetti (2011) and Tucker (2012) for more on this issue.

⁴ See Shin (2012).

⁵ See Borio and Disyatat (2011).

The answer to this question depends very much on the degree to which the substantial shortfall, relative to pre-crisis trends, of activity in the deficit economies represents a permanent impairment of supply potential as a result of the financial crisis and subsequent recession, or whether it will ultimately be reversed. Successive *Inflation Reports* and speeches by several MPC members⁶ have addressed this issue in the context of the United Kingdom, and I think it is fair to say that the evidence is presently inconclusive.

Chart 11 provides an assessment, drawing on IMF analysis, of the evolution of structural deficits and surpluses for two alternative scenarios, with the red dashed line corresponding to an assumption that supply impairment in the advanced economies as a result of the crisis is minimal (and therefore output gaps are correspondingly large), whereas the blue dashed line – which corresponds to the IMF's central case – assumes a relatively high degree of supply impairment (and therefore substantially smaller output gaps). In the former case, the bulk of the post-crisis narrowing in imbalances is attributed to cyclical factors, whereas in the latter they are attributed to structural factors. Clearly, depending how one reads the data, one can arrive at a different conclusion.

An alternative way into this is to look at what has happened to relative prices, rather than quantities. A natural counterpart of a rotation in demand from the advanced to the emerging world should be a fall in the real exchange rates of the former and a rise in those of the latter. By increasing the profitability in deficit countries of producing internationally tradable goods and services relative to that of non-tradables, that should facilitate the necessary shift of resources between sectors. The opposite is true for the emerging economies. Chart 12 shows such a shift has taken place since before the crisis, with both sterling and the dollar depreciating in real terms, and the renminbi appreciating. So there is evidence that at least some of the necessary structural adjustment has taken place, though in all likelihood it still has further to run.

What sorts of policies would facilitate the required adjustment without relying on sustained weakness in the indebted countries? At Pittsburgh, in 2009, the G20 identified five ingredients. First, surplus countries should take steps to boost domestic demand. Second, deficit countries should implement credible strategies to support private savings and restore fiscal sustainability. Third, exchange rates need to be allowed to reflect underlying fundamentals. Fourth, financial regulation and supervision should be strengthened to prevent the re-emergence of financial sector excesses. Fifth, structural reforms should be pursued, not only to boost long-term growth but also potentially to boost demand in the short run.

This sounds straightforward, but why has it in practice proved so difficult to achieve? First and foremost, the actors have not always shared the same diagnosis of the underlying problems. Second, in circumstances like the present, when there is still a significant margin of spare capacity in many economies, an expansion in activity in one country generates beneficial spillovers onto other countries (the opposite would be the case if there was excess demand and overheating). But policy makers typically do not take account of these spillovers when judging how much to stimulate their economies. Consequently uncoordinated

⁶ See for instance: Broadbent (2012), Miles (2012) and Dale (2013).

decision-making can lead to inefficiently low demand. Moreover, the space for policy action in the deficit countries is in most cases circumscribed, placing more of the onus on the surplus countries that have more room for manoeuvre.

Now, in principle, coordination could generate a better outcome by helping policymakers to internalise the consequences of their actions. And that is indeed what the G20 Framework for Strong, Sustainable and Balanced Growth set out to achieve. But implementing such a coordinated outcome turns out not to be so easy. In part that follows from the inherent asymmetry noted above, namely that the pressure to adjust is always greater on the debtor than the creditor. In addition, because multiple actions by multiple actors are needed, there is a genuine difficulty in ensuring that agreements are stuck to and free riding is avoided. And that is more of a problem, the weaker are the political ties between countries. For these reasons, examples of successful macroeconomic policy co-ordination are few and far between and have most often occurred when everyone is pulling in the same direction, such as at the time of the London G20 Summit in 2009 when policy makers around the globe were staring into the abyss. After all, as Samuel Pepys remarked: Nothing concentrates the mind like an imminent hanging.

But I do not wish to conclude by offering too downbeat an assessment of attempts to achieve a better economic outcome through international policy coordination. At a minimum, the exchange of views and a better understanding of country positions may help to avoid even worse outcomes. For example, in 2009, there was real concern that countries might respond by resorting to protectionist measures. That has, by and large, been avoided.

And some aspects of the international policy process have worked well. A good example is, in my view, provided by the redrawing of the scope of financial regulation. Here the G20 has set the overall political direction and tone, delegating the task of developing a detailed template for new international rules and regulations to the technocrats on the Financial Stability Board and the Basel Committee on Banking Supervision. This division of labour has enabled a substantial amount of new regulation relating to matters such as bank capital and liquidity requirements, financial sector compensation, and the principles for handling failing financial institutions to be developed in a relatively short period of time.

So, despite the modest progress in restoring our economies to Strong, Sustainable and Balanced Growth in the global economy, policy makers can claim some successes. And on that more upbeat note, let me conclude. Thank you!

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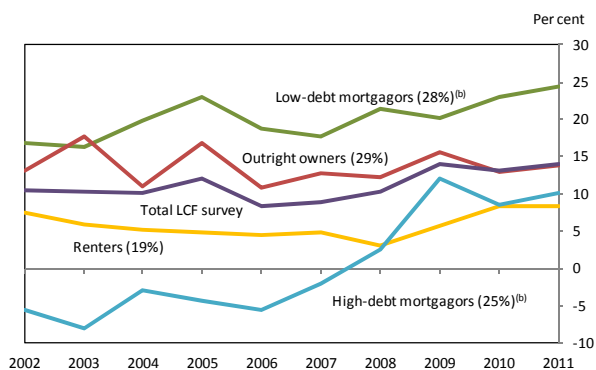
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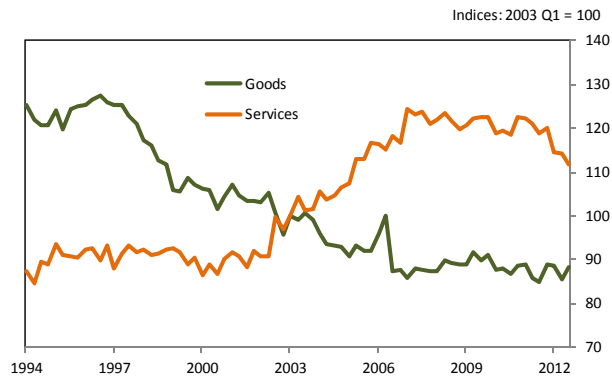
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Chart 1: Saving ratios of different groups of households^(a)



Sources: Living Costs and Food (LCF) survey and Bank calculations.
 (a) Saving ratios calculated using the average consumption and disposable income levels for each group of households. Numbers in parentheses show their share of total income in 2007. Shares do not sum to 100 due to rounding.
 (b) High-debt mortgagors are defined as having outstanding mortgage debt of more than twice their annual disposable income. All other mortgagors are low debt.

Chart 2: Ratio of UK exports to UK-weighted rest of G7 imports^(a)

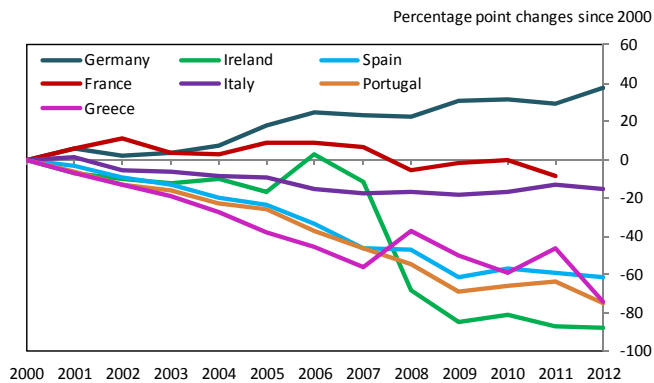


Sources: Eurostat, Japan Cabinet Office, ONS, Statistics Canada, Thomson Reuters Datastream, US Bureau of Economic Analysis and Bank calculations.

(a) Chained-volume measures of UK goods (services) exports divided by real imports of goods (services) in Canada, France, Germany, Italy, Japan and the United States, weighted using UK 2011 goods (services) export shares from the 2012 *Pink Book*. UK goods exports data have been adjusted for MTIC fraud by an amount equal to the ONS goods import adjustment.



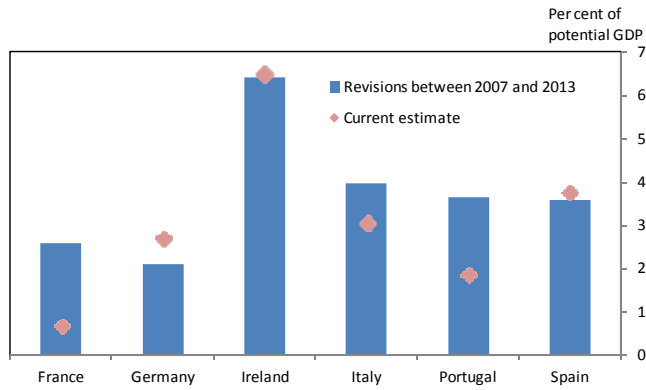
Chart 3: Net international investment positions (% of GDP)



Source: Eurostat.



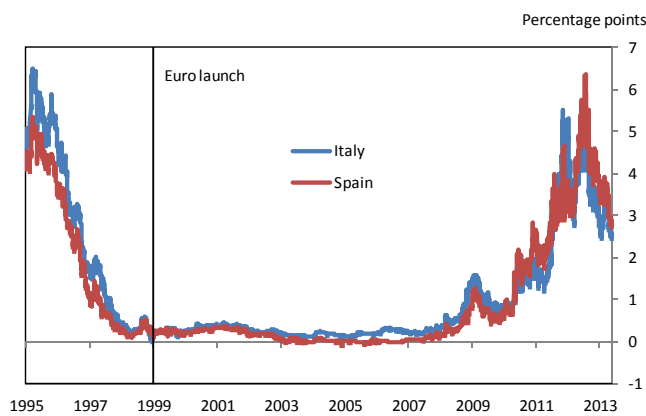
Chart 4: Pre-crisis euro-area output gaps^(a)



Source: International Monetary Fund *World Economic Outlook*, April 2007 and April 2013.
 (a) Data sourced from April 2007 and April 2013 IMF estimates of the output gap for each country in 2007.



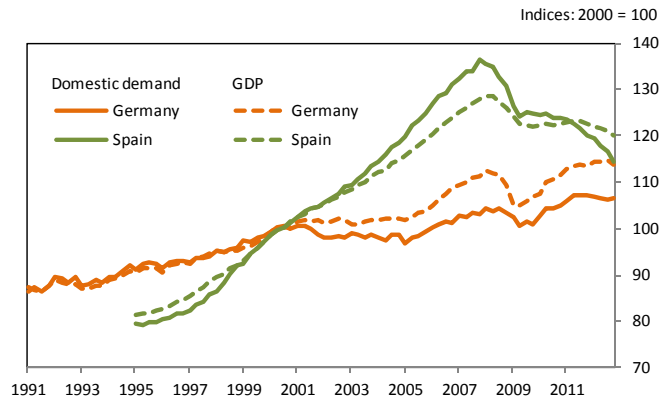
Chart 5: Spreads of 10-year sovereign bonds over Bunds



Source: Bloomberg.



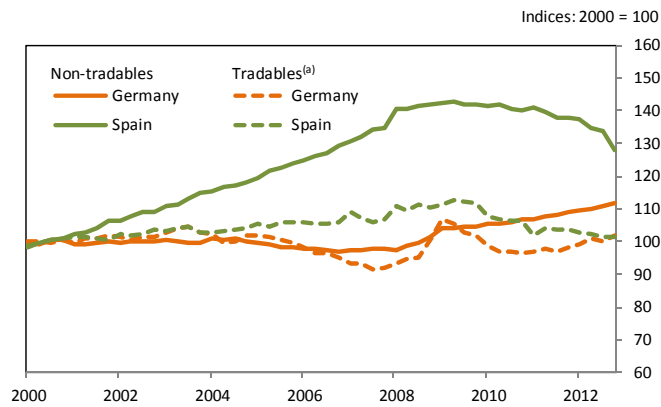
Chart 6: Domestic demand and GDP



Source: Eurostat.



Chart 7: Nominal unit labour costs



Sources: Thomson Reuters Datastream and Bank calculations.

(a) Tradable goods or services are defined as those potentially tradable, rather than actually traded. Tradable sectors are defined as: agriculture, forestry and fishing; industry; information and communication services; and financial and insurance activities.

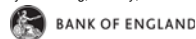
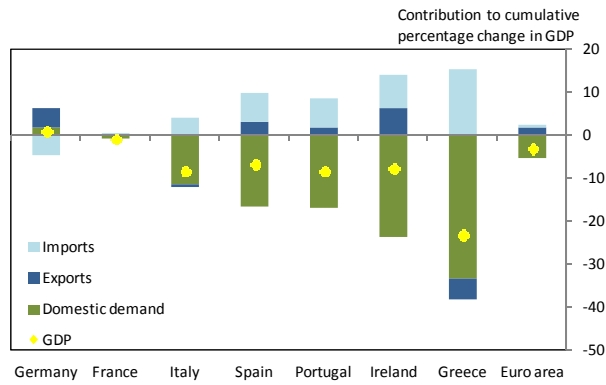


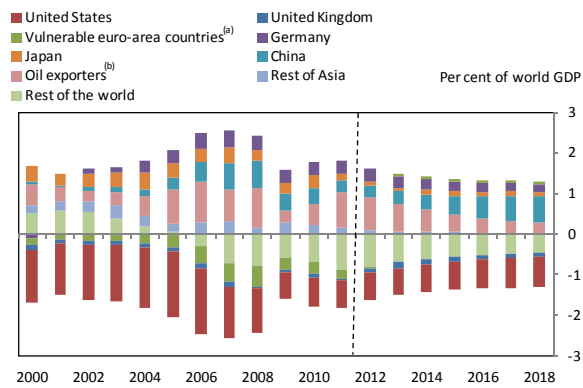
Chart 8: Euro-area activity since the pre-crisis peak^(a)



Sources: Eurostat and Thomson Reuters Datastream.
 (a) Pre-crisis peak is in 2008 Q1 other than for Italy (2007 Q3) and Portugal and Ireland (2007 Q4).



Chart 9: Global imbalances



Source: International Monetary Fund's *World Economic Outlook*, April 2013.
 (a) Includes Greece, Ireland, Italy, Portugal and Spain.
 (b) Includes Nigeria, Norway, Russia, Venezuela and the Middle East and North African region.

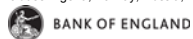
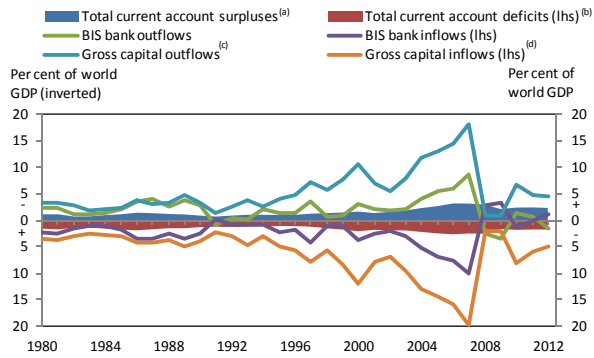


Chart 10: Global current account imbalances and gross capital flows

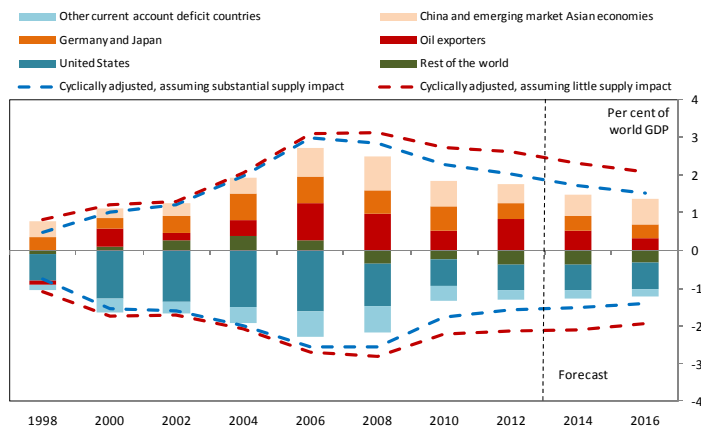


Sources: Bank for International Settlements, International Monetary Fund *World Economic Outlook* and Bank calculations.

- (a) Sum of global current account surpluses.
- (b) Sum of global current account deficits.
- (c) Sum of global net purchases of foreign assets by residents.
- (d) Sum of global net purchases of domestic assets by foreigners.



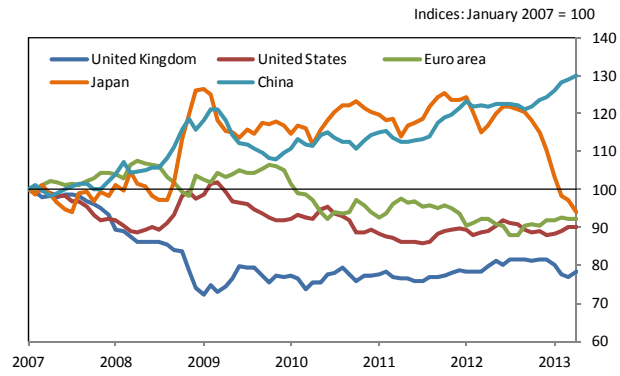
Chart 11: Global imbalances



Source: International Monetary Fund *World Economic Outlook*, April 2013.



Chart 12: Real effective exchange rates^(a)



Source: Bank for International Settlements.
(a) Deflated using consumer price indices.

