

Macroeconomic performance and global capital flows: is there a role for Europe to play?

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Abstract*

What role will Europe play in shaping the future structure of international capital flows? Can Europe be a key player in redressing the global imbalances that threaten the stability of the world economy? In this paper I address these issues by looking at Europe's savings and capital flows.

Looking at the global economic outlook we can identify three broad patterns that have emerged over the last decade. First, the US current account deficit climbed to \$665 billion in 2004 from \$136 billion in 1997. Second, the \$430 billion increase in the emerging market economies' aggregate current account surplus was the principal counterpart to the US deficit. This surplus is mainly due to the impact of the emerging market financial crises of the mid to late 1990s followed by the rise in the price of oil, which has pushed the Middle East and Russia into large surpluses. As a result of these changes, Asia has emerged as a key player in global capital flows. Many fear that the current position is not only unsustainable in the long run but also likely to prove highly volatile in the short term, implying a generally unstable macroeconomic environment. So far, the system has been kept in balance by shifting the adjustment to countries with floating currencies. The euro has taken most of the burnt and has appreciated by about 20% since 2003. This adjustment, however, does not address the fundamental problem of misplaced global capital flows, which is divergent savings rates.

The paper argues that global adjustment requires that Europe should play a greater role in world demand. As long as Europe – and Japan – retains structural excessive savings, the world economy's dynamism will continue to depend very narrowly on US excess consumption and on emerging Asia's excess investment. A necessary condition of successful global adjustment, therefore, is greater expenditure, in relation to potential output, in countries running big current account surpluses and vice versa for those in deficit. Even if the big shift must be among the developing countries, Europe has a role to play through adopting policies devised to generate additional demand, which would tend to push the overall EU current account into deficit.

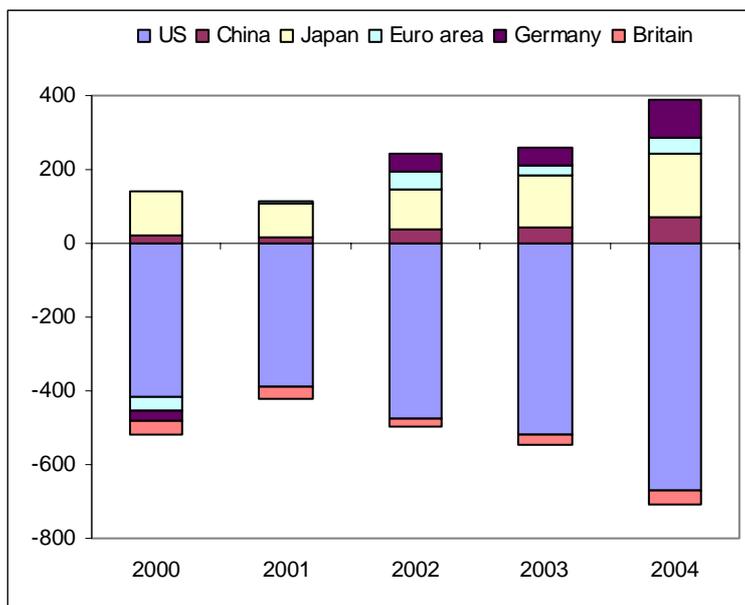
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Introduction

The global economy has large and widening imbalances across regions. These imbalances are reflected in three broad patterns that have emerged over the last decade. First, the US current account deficit climbed from \$136 billion in 1997 to \$665 billion in 2004 – equivalent to 5.7% of GDP. The deficit itself is not a reason of concern – over the last 30 years deficits rather than surpluses have been the rule – but it is its size and the fact that it is widening rapidly. An additional cause for concern is the existence of a large budget deficit in the US, amounting to 4.7% of GDP.

Second, in 2004 the \$430 billion increase in the emerging market economies' aggregate current account surplus was the principal counterpart to the US deficit. This surplus is mainly due to the impact of the emerging market financial crises of the mid- to late 1990s (notably Mexico, Asia, Russia, Brazil and Argentina) followed by the rise in the price of oil, which has pushed the Middle East and Russia into large surpluses. As a result of these changes, and this is the third point, Asia has emerged as a key player in global capital flows. Asian Central Banks, in particular, have been playing a key role in the management of rising FX reserves.

Figure 1: Current account balances, \$bn



Global financial imbalances have been widening and policy-makers worldwide are increasingly concerned about the risks associated with various adjustment processes and their implications for global financial stability and the growth of the world economy. In particular, many fear that the current position is not only unsustainable in the long run, but is likely to prove highly volatile in the short term, implying a generally unstable macroeconomic environment. Foreign lenders could decide to stop financing the US external deficit and move away from the dollar, either in favour of another currency such as the euro, or just as dramatically, requiring a risk premium on US liquid assets whose safety could not be guaranteed any longer. In either case, the repercussions could be

quite severe, with a decline in the value of the dollar, higher domestic interest rates and yields, and a global recession.¹

So far, the system has been kept in balance by shifting the adjustment to countries with floating currencies. The euro has taken most of the brunt and has appreciated by about 20% since 2003. This adjustment, however, does not address the fundamental problem of misplaced global capital flows. This problem is reflected in divergent consumption, investment and saving rates.

The US has been accused of consuming too many imported goods – imports of consumer goods represent roughly 17% of US GDP. However, it is not just a matter of trade. Excessive saving in Asia and Europe plays a key role. In 2004, gross savings rates (at market prices) were 14% of GDP in the US, 15% in the UK, 21% in the euro area and 28% in Japan. They were 32% in the newly industrialised Asian economies, 35% in the Middle East, 38% in developing Asia and 44% in China. The policy response, therefore, cannot only focus on curbing US consumption through the appreciation of the Asian currencies, in particular the renminbi – or through barriers to trade. Global imbalances could be redressed by tackling the misalignment of global investment and saving.

The debate so far has been focused on the role played by Asia in fuelling imbalances, but has not paid much attention to Europe despite its structural excess of savings over investment, a low return on capital and structural current account surpluses. The euro area generates about 21% of world GDP at market prices and had a current account surplus of 0.6% of GDP in 2004 compared with the 5.7% deficit of the US. Its gross national saving rate is about 19% of GDP compared with 13% in the US.

There are two fundamental differences between Asia and Europe. First, Asia's investments are robust. In China, for instance, they grew by 19.5% in 2004 compared to the previous year and they are expected to expand at around 20% this year. Investments grew at a double-digit rate in India, Indonesia, Taiwan and Thailand in 2004. This compares with a very modest 1.3% in the euro area.² Second, Asia's current account surpluses are channelled into foreign securities by governments and central banks as the private sector is not able, or not allowed, to do so. In Europe this role is played by the private sector (Genberg et al., 2005).

Unlike Asia, Europe has somehow contributed to keeping the system in balance in the short term through the appreciation of the euro. This, however, was not the result of deliberate policy choice but, rather, the unintentional consequence of the growing role of the euro as international currency. The euro appreciation has worsened the trade position

1 As Pierre and Hélène Rey (2005) point out, in a world where it can supply the international currency at will and invests it into illiquid assets, the US still faces a confidence risk. There could be a run on the dollar not because investors would fear an abandonment of the gold parity, as in the 1970s, but because they would fear a plunge in the dollar exchange rate.

2 There are differences among countries in the euro area. Investment in Spain, for instance, grew by 4.9% over the year in 2004, but they fell by 1.5% in Germany.

of some euro area member states such as Italy where eroding competitiveness has been associated, among other factors, to the currency strength.³

The situation would be even more critical in the case of 'hard landing'. A sudden and large drop in the dollar would substantially dampen the already modest expansion projected for the euro area and Japan, especially if accompanied by falls in bond, share and house prices. Therefore, with increasingly interdependent financial markets and a more integrated global economy, Europe does not have the option to take a back seat. The option is rather between taking, indirectly, the brunt of the adjustment or playing an active role in shaping the future structure of international capital flows. In other words, can Europe be a key player in redressing the global imbalances that threaten the stability of the world economy?

The paper argues that global adjustment requires Europe to play a greater role in world demand. As long as Europe – and Japan – retains structural excessive savings, the world economy's dynamism will continue to depend very narrowly on US excess consumption and on emerging Asia's excess investment. A necessary condition of successful global adjustment, therefore, is greater expenditure, in relation to potential output, in countries running big current account surpluses, and vice versa for those in deficit. Even if the big shift must be among the developing countries, Europe has a role to play through adopting policies devised to boost spending, encourage investment, generate additional demand and cut saving flows in the US. The paper argues that with an ageing population it makes sense to bring forward investment spending, as extra borrowing for this now would be low-cost.

Financial innovation has a role to play here. For example, one growth-friendly policy that may be attractive in the euro area, given currently weak household spending (especially as it costs little or nothing in terms of fiscal spending), might be to encourage the spread of financial products such as borrowing against housing equity and generally easier access to mortgage finance. Another example is the issue of long-dated, guaranteed public-sector bonds – such as, for instance, government-backed bonds or European Investment Bank-type bonds. Such innovations might provide the short-term boost to growth and jobs that most analysts agree is sorely needed in Europe – and this would benefit the global imbalances too, making Europe an integral part of the solution rather than part of the problem.

The paper is organised as follows. Part 1 looks at the excess of savings over investment in Europe. Part 2 focuses on Europe's pattern of growth and Part 3 concludes.

Part 1: 'A saving glut?'

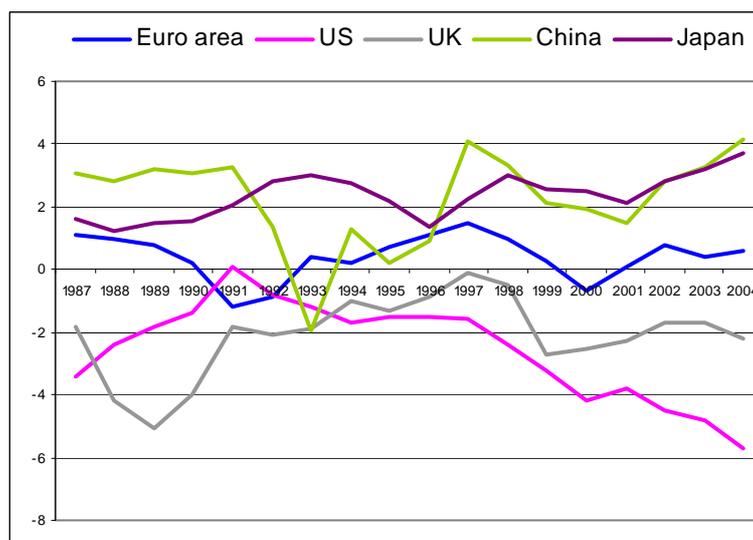
The president of the Council of Economic Advisors – and incoming Federal Reserve Chairman – Ben Bernanke (2005), and the *Financial Times* commentator Martin Wolf (2005a; 2005b), have argued that the large current account surpluses in the rest of the world, especially China, but more generally in East Asia and continental Europe, are the main source of global imbalances. These surpluses are absorbed by the US because of its

³ According to the OECD (2005) over the past five years Italy's cumulative loss of competitiveness has approached 25%.

role as the provider of the main international currency and liquidity.⁴ According to one school of thought (Dooley et al., 2003) central banks of developing countries, in particular China, have an incentive to subsidise US consumption by accumulating US Treasury bills and keep their currencies undervalued. Another line stresses the role of the US as a provider of safe financial assets to the rest of the world (Bernanke, 2005). Following the Asian and Russian crises, the high savings from emerging economies looked for a safe and liquid haven. US assets, especially Treasuries, provided the perfect vehicle. According to this view the global economy is now trapped in a 'global saving glut'.⁵

We tend to agree with Menzie Chinn (2005) that the 'saving glut' approach has some intellectual merits, but it has the downside of providing US policy-makers with a reasonable argument for inaction. It is certainly the case that the US current account deficit has its main counterpart surpluses in Japan, China, emerging Asian economies, oil-producing countries and Europe. These economies have shown growing surpluses in the current account balance while the US – and the UK – has been on the deficit side.⁶ For most of the past five years the gap between savings in the US and in the rest of the world has been key in driving excess savings in the US.

Figure 2: Current account balances as % of GDP



In Figure 3 and Table 1 it appears that the savings scarcity in the US is driven largely by the federal budget deficit rather than by the private sector. Unlike the household sector, where the decline in personal savings relative to GDP has been about 7 percentage

⁴ In 1966 Despres et al. (Rey, 2005) argued that the US was the world banker. It provided safe low-yield assets to global savers with a preference for liquidity. In exchange, US investors, with a lower taste for liquidity, saw investment opportunities in the rest of the world in the form of long term loans.

⁵ An excellent survey of the debate on the US 'twin' deficits is in Chinn, 2005.

⁶ However, rather than excess private savings flowing to the US, it has been more a case of accumulation of dollars and US Treasury securities by foreign banks (Chinn, 2005).

points since the mid-1980s, the business sector has kept a steady saving rate – up by about 1 percentage point over the last twenty years.⁷

Figure 3: Gross national saving as % of GDP

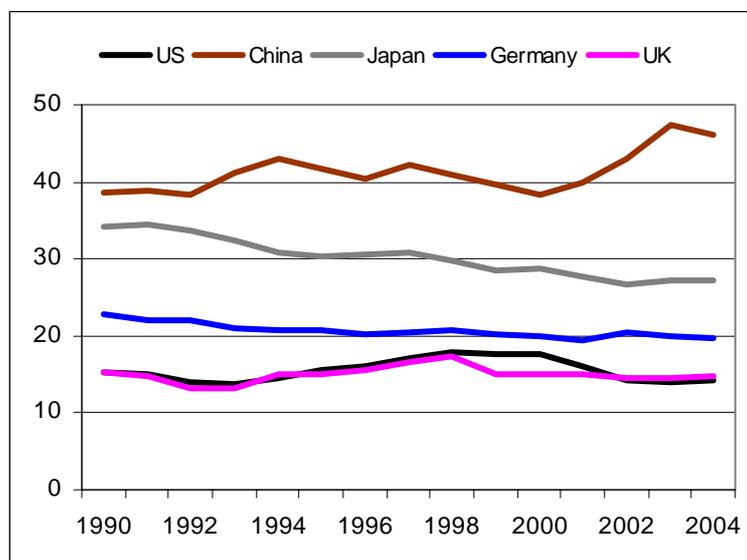


Table 1: Financial indicators, US

	2002	2003	2004	2005	2006
Household saving ratio ^a	2.0	1.4	1.2	0.6	1.2
General government financial balance ^b	-3.8	-4.6	-4.3	-4.1	-3.9
Current account balance ^b	-4.5	-4.8	-5.7	-6.4	-6.7
Short-term interest rates ^c	1.8	1.2	1.6	3.4	4.7
Long-term interest rates ^d	4.6	4.0	4.3	4.5	5.3

^a As a percentage of disposable income.

^b As a percentage of GDP.

^c 3-month euro-dollar.

^d 10-year government bonds.

Source: OECD, 2005.

As a result of its growing current account deficit, the US has accumulated net international debt of about \$3 trillion, making it the world's largest debtor. On the other hand, it has absorbed at least 80% of the savings that other countries do not invest domestically. The euro area, for instance, has a much higher savings rate than the US, which results in excess saving. In 2004, for instance, the euro area, far from absorbing the rest of the world's capital, ran a small saving surplus (\$36bn) of its own. Whereas America's foreign borrowing has accelerated, especially since 2001, the euro area has remained a lender. Though interest rates are low in both regions, the effect seems to have been very different. Recent empirical research (Warnock and Cacadac Warnock,

⁷ Figures from the Federal Reserve's website, www.federalreserve.gov.

2005) has suggested that large foreign purchases of US bonds have contributed to the low levels of US interest rates observed over the past two years.

Table 2: Financial indicators, euro area

	2002	2003	2004	2005	2006
Household saving ratio ^a	11.1	11.0	11.1	10.8	10.7
General government financial balance ^b	-2.5	-2.8	-2.7	-2.8	-2.7
Current account balance ^b	0.8	0.4	0.6	0.1	0.3
Short-term interest rates ^c	3.3	2.3	2.1	1.8	1.9
Long-term interest rates ^d	4.9	4.1	4.1	3.5	3.6

^a As a percentage of disposable income.

^b As a percentage of GDP.

^c 3-month interbank rate.

^d 10-year government bonds.

Source: OECD, 2005.

A bit of history

Twenty years ago, saving patterns in the US and Europe were broadly similar. In the mid-1980s, American households saved, on a net basis, around 9% of their disposable income. The British figure was 7%, the Spanish 8%, the French 9% and the German 12%. In the 1980s and 1990s, household saving rates fell both in Anglo-Saxon economies and, to a lesser extent, in many continental European ones. Germany saw only a small decline; Italy, with its growing number of pensioners, the largest. But the drop in household saving in the US was far bigger than in most of Europe for two reasons: bigger capital gains and more financial innovation (Lusardi et al., 2001).

But whereas household saving rates in the two regions diverged, government saving kept overall national saving rates closer than they would otherwise have been, at least during much of the 1990s. Public finances improved in both the US and Europe, but by more in the former. As a result, in 2000, America's overall national saving rate, at 18% of GDP, was not far below the European average of 21% of GDP.

Since 2000, however, the gap has grown much larger. The US drop in household saving has accelerated, whereas European households, on average, have been saving more. Americans now save just over 1% of their disposable income, compared with a euro area average of 10%. The US budget moved sharply into deficit, whereas Europe's public finances have seen less change. As a result, the US aggregate saving rate is now around 13% of GDP, compared with just below 20% for the euro area.

Is Europe caught in a low growth-high saving equilibrium?

In the US the 'wealth effect', that is the rise in perceived wealth associated with rising house prices, is mainly responsible for the drop in household savings. According to the OECD figures (OECD, 2005), in 2003 net household wealth was 546% of nominal disposable income – an increase of about 14% since 1993. The expansion of household wealth was less strong in Europe – in Germany, for instance, it grew by just above 5% in the decade between 1993 and 2003 – but the actual share of nominal disposable income

is similar to the American one or even bigger. In Germany household wealth represents about 500% of nominal disposable income, while in France and Italy it is about 600% and 700% respectively.

The availability of financial products, such as easy mortgages and re-mortgages, has been playing a key role in transforming the 'wealth effect' in consumption and in substantially reducing saving rates. Through these products American consumers can 'cash in' the capital gains accrued in the property market. Low unemployment rates have also encouraged confidence. US consumers dare to borrow – and they can and do, maintaining high rates of consumption and a buoyant economy. On the top of this, tax cuts and government spending have increased private consumption. This, of course, has resulted in the strong growth of indebtedness⁸. In fact, in the US each household's liabilities are equivalent, on average, to almost 120% of disposable income.

In Europe, on the contrary, borrowing is much more difficult. In France and Italy each household's liabilities amount to 70% and 40% of disposable income respectively. Only in Germany are liabilities over 100% of household disposable income. The impact of housing wealth on consumption appears to be positively correlated with indicators of mortgage market size such as household mortgage debt ratios, indicating that the mortgage market is crucial in translating housing wealth on consumption. There are, however, substantial differences among countries with ratios to GDP currently above 60% in Denmark, the Netherlands and the UK and below 25% in France, Italy and Greece (OECD, 2004).⁹ As a result, despite the good recent performance of the property market, especially in Spain, Ireland and the Netherlands¹⁰, Europeans continue to rely on saving.

⁸ Almost the entire 2004 federal deficit of \$369.4 billion was financed by foreign central banks' accumulation of \$355.3 billion of US currency and treasury securities. This is clearly unsustainable in the long run. For a discussion see Chinn, 2005.

⁹ The influence of the housing market on consumption depends on the extent to which homeowners are able to borrow against housing wealth. Data, however, are of poor quality and tend to show that the euro area has had virtually no development of the 'equity withdrawal' option. Only the Netherlands has the 'equity withdrawal' option. Of course, outside the euro area the UK has developed a market for remortgaging. The OECD (2004) calculates housing equity withdrawal by subtracting the household sector's residential investment from the net increment in their mortgage debt, but this measure is not ideal.

¹⁰ On housing wealth and prices Europe presents a mixed story. Some markets have performed much better than the US one. In Ireland, for instance, national prices grew by 7.5% over the period March 2004-March 2005 (12.9% over equivalent period to March 2004). Spain has experienced the strongest boom in Europe, but this is easing now. Germany, on the other hand, is still weak after the 'unification' bubble burst. Prices remain quite high nevertheless.

Figure 4: House prices



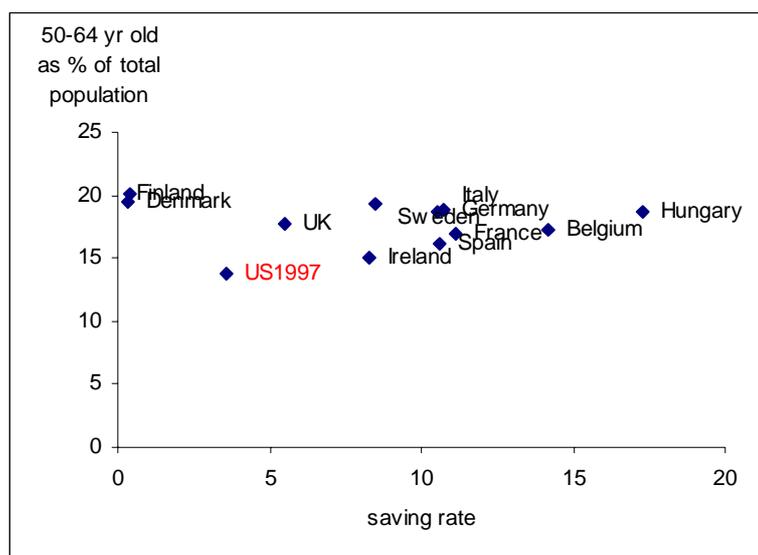
Relatively high unemployment – in the euro area 9% of the workforce is unemployed – as well as the critical state of public finances in Europe’s main economies, especially those that are members of the monetary union, and the ongoing reform process also explain the relatively high saving rate. The goal and requirement of reducing public deficits, which for Germany, France and Italy well exceed the 3% of GDP reference value set in the Stability and Growth Pact,¹¹ ‘to close to balance’ is a trigger for saving. European taxpayers are driven to expect, sooner or later, more taxes and cuts in benefits and spending – to which the rational response is to save even more.

Despite these factors, Europe’s high saving rate is mostly explained by its demographic structure. About 20% of the population – the so-called baby-boomer generation – is now in the pre-retirement, 50-64 age group. According to the life-cycle theory, which links an individual’s age, consumption and saving decisions,¹² individuals in this age group enjoy higher labour income than younger people, tend to repay debts and start to save on a net basis for retirement. Aggregate saving is relatively high for the pre-retirement age group.

¹¹ The Stability and Growth Pact was established two years before the launch of the European Monetary Union, in 1999, as a commitment from member states to maintaining balanced fiscal accounts over the medium term. It is regarded as an attempt to establish some form of fiscal policy coordination among euro area member states. See Subacchi, 2005.

¹² This has been explored within the context of the permanent income hypothesis (Friedman, 1957) and the later life-cycle hypothesis (Modigliani and Brumberg, 1954; Ando and Modigliani, 1963). Both theories imply that consumption and saving will be smoothed out through an individual’s lifetime.

Figure 5: Saving ratios for 50-64 age group



High saving mode may be temporary for Europe

We argue that it is just a matter of time before saving rates begin to drop in Europe as well. In the US low saving rates are triggered by widespread confidence as well as by a younger population – with more people in their high spending-low saving years. In Europe, on the other hand, a fall in saving is likely to be triggered by a higher proportion of pensioners.

According to the life-cycle theory, at retirement income normally decreases and individuals start to rely on income from pension investment returns. They may also dis-save, which involves selling off some of their financial assets. As a result, the saving rate, which depends critically on the relative size of different age cohorts in the population, will eventually decline as a percentage of national income. Given current, quite extreme, demographic trends in Europe, the theory predicts that population ageing will result in declining rates of saving as older households begin to draw down their retirement savings in order to support consumption. In some countries, such as Italy, the saving trend may already have moved downwards.

This scenario is far from reassuring. Along with potential disruption of financial asset markets if large numbers of pensioners begin to sell off their assets to pay for retirement consumption,¹³ population ageing also has strong implications for growth and productivity. Ageing implies a contraction of the future workforce in many industrial countries. The goods and services that the retired population will be able to purchase, irrespective of the source of their income, will be produced by relatively fewer workers. This will reduce domestic investment opportunities because employers will have less need to provide new equipment and facilities for additional workers. Excessive growth in the capital stock relative to labour supply will result in a drop in the real rate of return on

¹³ Empirical evidence, however, shows that the ‘asset meltdown hypothesis’ is the worst case scenario. Consumers typically decumulate assets at a less rapid rate than the life-cycle suggests. Uncertainty has a major influence on the pace of wealth decumulation during retirement because of the uncertainty of when death will occur and unforeseen contingencies.

capital. The relatively greater scarcity of labour will also reduce capital's marginal product, resulting in lower returns. Productivity, therefore, has to increase in order to maintain the current level of output, to sustain the next generation's consumption as well as the consumption of the pension age group and to avoid a drop in average living standards.

Part 2: Current account adjustments and currency fluctuations

If the long-term scenario is far from reassuring, most of the trends are easily predictable; hence, it should be easier to devise the appropriate response. In particular, we see now a window of opportunity, which is the savings of pre-retirement baby-boomers. These funds are available now, at low cost, and should be put to use to develop and renew infrastructure. Investing in infrastructure projects could provide domestic investment opportunities and stabilise returns, increase productivity, absorb some of Europe's unemployment and, hopefully, put the economy back on track with its potential. We see a sound financial case now for intervention. Postponing this kind of intervention may miss the window, since returns and productivity are already beginning to fall.

Economic theory predicts that in the medium term the high saving rate of baby-boomers in the final high-earning years of their working life is likely to result in a surplus of saving *vis-à-vis* the investment opportunities in the domestic economy, with a consequent drop in the real rate of return on capital. How the adjustment can be achieved depends on the economy's openness. In a completely closed economy, domestic investment and national saving would have to decline together. In economies open to the rest of the world, however, rapidly ageing countries can export some of their savings to less rapidly ageing countries elsewhere in the world. In other words, in an open economy future rates of saving and investment are not necessarily synchronised. Fluctuations in the domestic saving and investment balance would be absorbed by changes in the current account balance. Indeed, significant parts of the required macroeconomic adjustments can be channelled through exchange rate movements and external-sector transactions.¹⁴

The timing and size of demographic transitions differ widely across countries. Countries with faster demographic transitions and greater population ageing are likely to experience an appreciation of their currencies and strengthening of their current account balances. Such changes cushion the rapidly ageing economies from the full effects that demographic shocks would produce in a closed economy. The openness of an economy works to mitigate the negative consequences of population ageing on domestic output and consumption (Bosworth et al., 2004).

Improvements in the net international investment position

The impact of ageing on investment and saving in Europe has begun to be evident. In Germany, for example, where almost 20% of the population is in the age group 50 to 64 and the saving rate is around 11% of disposable household income,¹⁵ the current account balance has been in surplus since 2002 and is projected to increase in 2006 to €140 billion – or 4.9% of GDP – from €120 billion – or 4.2% of GDP – in 2005 (OECD,

¹⁴ A critical question for future cross-border capital flows is whether population ageing in the high-income countries will reduce the rate of domestic investment by more than it reduces saving.

¹⁵ Broadly the same rate as in the late 1980s. The rate dipped down to 9.7% in 2000.

2005). Even if the increase has been mainly due to a strong improvement in the foreign balance as a result of strong export growth, invisibles have been improving too and in 2004 net investment income posted a small surplus of €400 million. Foreign assets held by residents have grown by 170% over the period 1999 to 2004, from €266 billion to €719 billion.

Table 3: External indicators, Germany, \$bn

	2002	2003	2004	2005	2006
Goods and services exports	723.0	872.4	1029.5	1136.0	1220.0
Goods and services imports	632.4	767.3	890.4	985.0	1053.0
Foreign balance	90.6	105.1	139.2	150.0	167.0
Invisibles, net	-44.3	-53.8	-34.2	-30.0	-26.0
Current account balance	46.2	51.3	105.0	121.0	141.0

Source: OECD, 2005.

Figures for France shows a similar story, with the projected deterioration of the current account balance mainly due to the slowdown in exports growth – and the much stronger import growth. In 2005 exports are expected to grow by just above 3% while imports growth should be almost 6% (OECD, 2005). Net investment income has been in surplus since 1997. In 2004, for instance, it was over \$8 billion. Foreign assets held by residents grew by over 80% between 1999 and 2004, from €291 billion to €537 billion.

Table 4: External indicators, France, \$bn

	2002	2003	2004	2005	2006
Goods and services exports	390.6	455.9	522.3	568.0	607.0
Goods and services imports	363.3	435.3	511.0	576.0	608.0
Foreign balance	27.3	20.6	11.3	-8.0	-1.0
Invisibles, net	-14.0	-12.8	-17.3	-14.0	-12.0
Current account balance	13.3	7.8	-6.1	-22.0	-12.0

Source: OECD Economic Outlook, 77, June 2005.

Table 5 provides evidence for the diverse outcomes on current account. The table is ordered and grouped by average current account performance, from low to high, but also includes data from country highs and lows. The point to notice is the strong similarities between the UK and the US and how these two countries diverge from the euro area in terms of current account performance.

Table 5: Current account performance as a percentage of GDP, 1987-2004

	Low	Average	High
Euro area	-1.2	0.4	1.5
Germany	-1.8	0.8	4.6
France	-0.8	0.7	2.9
Italy	-2.3	0.0	3.2
Netherlands	1.8	3.5	6.4
Finland	-5.4	2.6	7.5
UK	-5.1	-2.1	0.1
US	-5.7	-2.5	0.1

Source: Eurostat.

A more prominent international role for the euro?

Currency appreciation is another aspect of the adjustment process in rapidly ageing economies. The euro area's investment-saving model and demographics point to current account surpluses in the medium term¹⁶ which, in their turn, are likely to result in the appreciation of the euro.

There are other factors, however, some of which are already in play, that suggest further strengthening of the euro. As the dollar is increasingly perceived to be at risk of strong depreciation because of the US twin deficits, investors and central banks have been diversifying out of the dollar and increasing their exposure to the euro and euro-denominated assets. As a result the role of the euro as an international currency has strengthened. Despite a disappointing beginning in 1999, the euro depreciation was fully reversed and the European single currency appreciated strongly in 2002-04.

An international currency is defined as one that is used outside its home country. The euro fulfils the definition well as its international use as a 'medium of exchange', to invoice trade and in financial transactions, has continued to grow during the first five years of its life. About half of the euro-area trade with non-euro-area residents is invoiced in the new currency. The euro's share in international debt securities has risen to above 30%. This compares with under 20% for the pre-1999 legacy currencies. Using the comprehensive triennial survey of foreign exchange trading volume put together by the BIS, Chinn and Frankel (2005) show the dollar still easily in first place in 2001, at 85% of all spot trades – out of 200% –, followed by the euro at 43% and the yen at 26%. The most recent triennial BIS survey, covering April 2004, showed the dollar still at 85% of all spot trades and the euro at 44%. If forwards and swaps are included, the dollar was involved in 89% of all transactions, and the euro in 37%. The European currency is now ahead of the yen, though still far behind the dollar, and has rapidly gained acceptance (Chinn and Frankel, 2005).

¹⁶ The long-term outlook is likely to be rather different.

Another measure is the use of the currency as denomination in cross-border financial transactions. Soon after its debut the euro came into wide use to denominate bonds. Within Europe there was a strong increase in issues of corporate bonds, denominated in euros, together with a rapid integration of money markets, government bond markets, equity markets and banking. However, such activity did not meet the definition of 'international currency use' because it was taking place inside the currency's home region (Chinn and Frankel, 2005). Outside Europe, the euro has been a success as well. Detken and Hartmann (2000) studied the data from the euro's first year in operation, doing a careful job of netting out intra-euro-area holdings in order to be able to trace back a measure of euro precursor currencies for five years before 1999 that is comparable with post-1999 data. They found a greater increase in the supply of euro-denominated assets outside Europe than an increase in demand. The stock of international debt denominated in euros increased from about 20% on the eve of EMU to 30% in 2003 (Rey, 2005:114).

For this paper a more relevant measure of a currency's international use is its use as a reserve currency. As demand for an international currency affects its value, central banks' diversification out of the dollar and stronger preference for the euro (see Table 6) has resulted in the appreciation of the latter in the last three years. The increase in the average demand¹⁷ is one of the disadvantages of an international currency. If assets are made available to foreign residents, an inflow of capital would cause the currency to appreciate and render exporters uncompetitive on world markets.

Table 6: Share of national currencies in total identified official holdings of foreign exchange, end of year, %

	1965	1973	1977	1987	1997	1999	2001	2002	2003	2004
All countries										
US dollar	56.1	64.5	79.2	53.9	65.2	71.0	70.7	66.5	65.8	65.9
Japanese yen	0.0	0.1	2.2	6.8	5.8	6.4	5.2	4.5	4.1	3.9
Pound sterling	20.0	4.2	1.6	1.9	2.6	2.9	2.7	2.9	2.6	3.3
Swiss franc	0.0	1.1	1.9	1.7	0.3	0.2	0.3	0.4	0.2	0.2
Euro	0.0	0.0	0.0	—	—	17.9	19.8	24.2	25.3	24.9
Deutschmark	0.1	5.5	9.3	13.8	—	—	—	—	—	—
French franc	0.9	0.7	1.1	0.9	—	—	—	—	—	—
Netherlands guilder	0.0	0.5	0.7	1.2	—	—	—	—	—	—
ECU	0.0	0.0	0.0	13.6	—	—	—	—	—	—
Other currencies	22.9	23.6	4.1	6.4	3.8	1.6	1.2	1.4	1.9	1.8

Source: Chinn and Frankel, 2005b; figures for 1997 and 1999 to 2004 are from IMF, 2005.

¹⁷ On the other hand, advantages are convenience for the country's residents; more business for the country's banks and other financial institutions; seignorage; political power and prestige. For an overview see Chinn and Frankel (2005b).

Given the uncertainty surrounding the dollar, central banks are likely to continue their diversification out of the dollar. Clearly, it is difficult to pinpoint the net effect of diversification and determine how much of the euro strengthening is due to the undervaluation of the Chinese currency. Again, the recent move towards a basket peg – as against the dollar peg – has clear implications for the euro as an international currency as well as on its value in the short and medium term.

Part 3: It all depends on domestic demand

In this section we argue that there is a misalignment between the eurozone model of growth and the role of the euro as an international reserve currency. Western Europe does not have developing countries' scope for catch-up. Also, it does not enjoy the 'exorbitant privilege' of having the key international reserve currency – and therefore being able to live beyond its means (Eichengreen, 2004). On the other hand, because of the increasing use of the euro as an international reserve currency and because the large and liquid market in euro-denominated government securities provides an attractive alternative to the US treasuries,¹⁸ Europe is under pressure.

External trade remains the main driver of growth in continental Europe where, unlike the US and the UK, external demand provides a bigger contribution to GDP growth than domestic demand. Exports contribute about 27% to GDP growth in Germany, France and Italy, but only 10% in the US. In Germany, for example, foreign trade helped support growth in the face of stagnant domestic demand. In 2004 domestic demand was flat while exports grew by 7.5% from the previous year. This helped economic growth and in fact GDP was up by 1.0% from the previous year. Net exports contributed by 1.0% to GDP growth.

With the creation of the single currency in 1999 the share of trade inside the euro area broadened. As a result the euro area economy became less open to international trade than it was previously be the case and therefore less sensitive to the exchange rate. Despite the currency appreciation of about 30% between the beginning of 2003 and 2005, exports have not performed that badly. In 2003 exports from the euro area grew by an extremely modest 0.6% from the previous year, but they were up by 6.0% in 2004. The recovery in the world demand offset the possible adverse impact from the currency appreciation.

The strength of the euro has certainly an impact on GDP growth, but this seems smaller than it is widely expected. Poor economic growth in Europe has more to do with investment and consumption that have recently performed badly, despite the fact that the latter should have benefited from the strong euro *vis-à-vis* the dollar.

Changing the policy strategy

What, then, is the macroeconomic policy mix consistent with Europe's demographic structure and saving-investment model? In other words, what policy strategy is appropriate to current account balances that are consistently in surplus?

¹⁸ Eichengreen (2004:25) compares the current situation with the years before the crisis and abandonment of the Bretton Woods system. Unlike today, when the euro provides a viable and credible alternative to the US dollar, in the late 1960s shifting out of dollars into sterling was not a way to avoiding capital losses.

Economic theory identifies restraining domestic demand and resisting capital inflows as the policy mix necessary to support consistent surpluses on current account. Restraint on domestic demand – through tight fiscal policy or price-income policy – has the effect of holding down the consumption of imports as well as moderating the relative growth of prices for non-traded goods and services. Policies to resist capital inflows are necessary to curb the strength of the currency, the accumulation of foreign exchange reserves and the consequent expansion of the domestic monetary base which can result in inflationary pressures. As a result of such a policy mix interest rates and inflation rates will remain relatively low and growth will be export-led rather than consumption-led.¹⁹ Export manufacturers gain most from this policy mix as they benefit from a relatively favourable real exchange rate, from elevated profits and from enhanced international liquidity. However, the domestic non-tradable goods sector suffers from unfavourable terms of trade, constrained wages and a relative lack of investment.

Key to the above pattern is the active policy of restraining capital inflows. But is it still appropriate for a case, such as Europe, where current account surpluses are increasingly the result of capital outflows on the back of excess saving and where the strength of the currency is increasingly determined by exogenous factors?

Erik Jones (2003:209) argues that the pattern of policies to support consistent current account surpluses is regarded as more deliberate than unintentional. The best example is offered by the cases of the US and China. The latter is accused by the former of accumulating reserves in order to keep its currency artificially low. On the other hand, the US, despite being indicated as the main culprit of the current imbalances, cannot be accused of striving for consistent current account deficits *per se*. The euro area economies, however, provide a counter-example – that is, of an unintentional pattern of supporting current account surpluses. Indeed, as we have discussed in this paper, surpluses are increasingly driven by external and structural factors rather by intentional strategies. Given such factors, it is now necessary to *intentionally* change the policy mix and switch to a pattern of consistent deficits on the current account. This means encouraging greater expenditure, in relation to potential output, in countries running big current account surpluses

Could profligacy be a virtue?

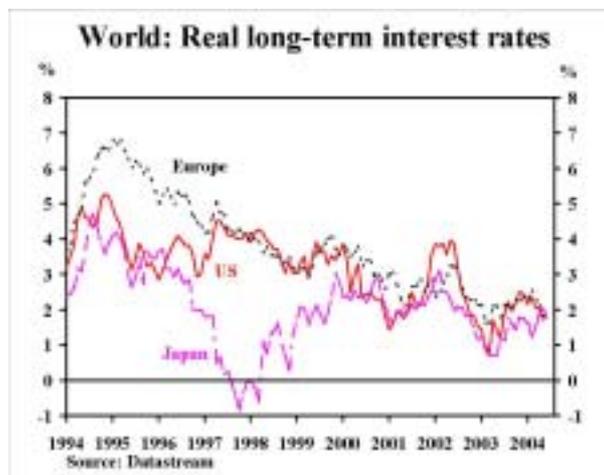
The policy strategy resulting in consistent deficits can be characterised in terms of tight monetary policy, loose fiscal policy and real exchange rate appreciation. The tight monetary policy, through interest rates, slows the growth of domestic prices while, at the same time, attracting foreign capital and pushing up the exchange rate. Meanwhile, loose fiscal policy fuels domestic demand which spills over into imports – and potential exports even as these traded goods become relatively cheaper than non-traded goods as a result of the exchange rate appreciation. The advantages of this policy mix are domestic. Loose fiscal policy fuels consumption, tight monetary policy reins in inflation and an appreciating exchange rate improves the terms of trade, allowing for cheaper imports.

¹⁹ Asian countries have long been committed to policies of export-led growth. Pegged exchange rates and resistance to pressures for revaluation as their economies and current account strengthen have been at the centre of their development strategies. The condition to achieve faster growth is to have lower living standards for the time being, relative to those that could be achieved in the short-term if currencies were allowed to appreciate (Eichengreen, 2004).

The euro area economy at the moment presents two inconsistent outcomes. On the one hand, the balance on current account is in surplus – and the appropriate policy mix would aim at currency depreciation. On the other hand, the strength of the euro would be consistent with a policy strategy that supports consistent current account deficits. Given the external factors affecting the euro's value it is necessary to switch focus from an export-led to a demand-driven pattern of growth and therefore promote a policy strategy that is geared to domestic demand. Consistent currency appreciation makes exports less competitive,²⁰ but makes imports cheaper, allowing more consumption of imported goods or – and this could be a negative effect – switching preference from domestically produced goods to imports. Loose fiscal policy should encourage domestic demand while domestic firms will concentrate on high-value goods and non-tradable sectors – such as personal and healthcare, which is consistent with ageing – rather than on low-value goods aimed at foreign markets.

Long-term interest rates in Europe are relatively low and are projected to remain so despite the widening of public deficits and debts in most euro area economies. This is puzzling as consistency with economic theory would lead one to expect that future deficits as well as government borrowing should have an effect on long-term interest rates.²¹ In the euro area, therefore, the impending increases in public expenditures associated with populations that are ageing even more rapidly than in the US should put upward pressure on debt stocks and hence on interest rates. But investors do not seem interested in applying a premium to euro-area long-term securities. This is due to the sense of stability following the establishment of the monetary union, which has widened the gap between US and European short-term interest rates and narrowed the gap between long-term interest rates,²² the strength of the euro and excess liquidity over investment opportunities.

Figure 6: Real long-term interest rates



²⁰ This is one of the factors, others being labour costs, location etc.

²¹ And presumably crowds out components of private demand (Chinn and Frankel, 2005).

²² Recent research (Chinn and Frankel, 2005) indicates that over the past three decades, short- and long-term interest rates have been driven more from the US side than the European side. However, since EMU went into effect, long-term real rates in both the US and the euro area have tended to move in such a manner as to close any gaps that open up between them.

Conclusion: The policy response and the role of financial innovation

In response to the ballooning global imbalances the US administration has been exhorting governments in Europe and Japan to continue with structural reforms of labour, financial and product markets, in the hope that success in these dimensions will lead to an acceleration of growth and hence additional American exports.²³ Is this the right response? Empirical evidence has shown that structural reform has little effect on the current account balances. Similarly, even if there are evident benefits from Europe's and Japan's finally running current account deficits, the impact on the US current account deficit may be smaller than expected²⁴.

Current account deficits in Europe – and Japan – are only part of the story. The key point here is to recognise Europe's structural features and embrace appropriate economic policies. The European economy should be helped to grow at a sustainable rate and close to its potential. Ultimately it should be in the position of replacing the US in the driving seat when its economy will eventually grow at a much slower rate.

What needs to be done? We argue (Subacchi and Rossi: 2005) that governments in Europe should exploit the current window of opportunity to mop up domestic savings through issuing long-dated government-backed bonds and channel it towards domestic investments. Issuing long-dated government bonds would bring in cheap government-backed capital which draws in pensions together with private operations. Such securities, in fact, would to meet the demand for low-risk investment products that smooth returns over a number of years, mop up Europe's savings and channel it towards domestic investments. Because pre-retirement savers are typically risk-averse, we stress that long-dated securities should be government-backed as against company-backed. Investing in infrastructure projects could provide domestic investment opportunities and stabilise returns, increase productivity and absorb some of Europe's unemployment.

A key implication of the assessment for potentially higher government-backed investment given investor demands for such papers is that the 'steady state' government debt/GDP ratio is not exogenous to the system – it may vary according to the population age and savings structure. This suggests that European government debt is not 'high' but 'low'. More aggressive fiscal expansion (or rather public investment) may be acceptable during the next decade prior to the retirement of the baby-boomers, who would then receive their pensions from the proceeds of the long-term bonds used to fund the short-term investment expansion. Investors of this type favour government-backed bonds for reasons of security and regulations in the pensions market. Indeed, adjustment of supply might help savers avoid an undesirable boom-bust cycle in bond markets during the pre- and post-retirement impact of the baby-boomer generation. In as much as increased investment activity now would boost the economic situation and jobs, the eurozone economy could benefit considerably from tapping this source of funds.

Certainly concerns over public debt do not seem consistent with the very strong demand for long-term government debt at fairly low interest rates, as witnessed by the demand

²³ Along with putting pressure on the Chinese authorities to revalue the renminbi.

²⁴ Research has shown that while for each 1% increase in US income total imports rise by 2.2%, each 1% increase in US trading partners' income increases US exports by only 2%. See Chinn, 2005.

for the recent historic issue of 50-year bonds by the French government²⁵ and by generally firm demand for long-dated government bonds, typically by long-term investors such as insurance and pension funds. This may be because neither the basic form of economic theory nor the EU's 'received wisdom' on government debt seems to properly address the institutional framework of savings and thus the 'demand side' for investment instruments.

The institutional requirement and investor preference for much of this money to be placed in instruments such as government debt may suggest that government debt levels should be rising – and can safely do so without pressuring interest rates. It may be argued that such demand for government paper against a fixed supply should drive down interest rates and force more flows into private business investment which is typically seen as more productive than government investment. The latter process simply may not happen, however, if, in a multi-country context, the search for quality government securities to fulfil investor demand for such categories just drives investment overseas or into other acceptable vehicles. Likely candidates are in the first case US bonds and in the latter the property markets.

But fear of rising government deficits and debt seems to be precluding this adjustment mechanism. Instead of the 'ad hoc' targets for deficits and debt across the euro area, targets could be maintained but adjusted to take into account the population savings cycle and the investment instruments required for meeting pension plans. Then there could be an equivalent long cycle in demand for EU government debt that permits a rise in this debt over the next decade without this putting pressure on EU interest rates or causing 'crowding out'. This view, however, is in stark contrast to recent efforts to cut debt.

Clearly there is a risk that if fiscal targets were to be relaxed, the extra money might not go to infrastructure after all but into less desirable forms of spending. According to this view, tough targets have to be maintained to reduce 'bad' spending habits and governments cannot be trusted. Unfortunately nobody seems to believe that European governments would stick to a 'golden rule' and certainly their current credibility, especially after have breached the Stability and Growth Pact, is very much in tatters. This is a risk, but perhaps one worth taking for the sake of the chance that a change in policies might help Europe emerge from the current gloom. Otherwise, Europe, especially its unemployed, will continue to pay a high price for what is essentially a problem of the lack of trust in its governments and institutions. Europe's gloomy economic outlook, coupled with the US twin deficits, increases the chances of a hard landing for the world economy. Unless we find an alternative for the excess saving of Europe – and Japan – for how long is the current situation sustainable, given that non-US investors do not have an infinite appetite for US Treasuries and so yields will, eventually, have to rise?

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²⁵ In February 2005 the French Trésor, after a quick consultation, issued €6bn in 50-year bonds. Initial plans were for a €3-€5bn issue with a coupon of 4%, but more than €19bn was bid for, so the deal size was increased.

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