The theme for the next 10 years: Rebalancing!

After years of carefree spending, the structural imbalances of the global economy now have to be dealt with.

The latest economic statistics confirm that the worldwide recession is now behind us. This is worth getting excited about as we have just pulled out of the worst financial crisis since the Great Depression. If not for the exceptional efforts made by governments and the monetary authorities, the economic outcomes could have been far more painful. The sharp rebound in economic growth in the United States and in Canada since the end of 2009 is a comfort as it suggests that the economies on both sides of the border are poised to spring back to life with the same pre-recession vigour. That said, upon closer inspection the harsh reality is far more complex. We should take a look at the excess that characterized the previous phase of economic expansion.

If this financial crisis was so devastating, it is partly due to the structural imbalances in the global economy that had accumulated during this last cycle. Among these imbalances was a high level of household debt in many industrialized countries, made easy by reckless financial innovations and inadequate regulations. Many governments were also grappling with chronic debt problems. Added to this are international trade imbalances, including the huge deficit of the current account\(^1\) in the United States and the combined surpluses of emerging countries.

This recipe of imbalances is an explosive mix for economic growth over the long term. Sooner or later, a rebalancing is in order. The financial crisis and the resulting recession may have been the tipping points to these adjustments.

TOWARDS LESS SUPPORT FROM CONSUMERS

First of all, consumer behaviour should make an about-face. During the last cycle, easy credit was largely responsible for boosting consumption in industrialized economies. Before the recession, more than 70% of real GDP in the U.S. relied on household spending, a level that was clearly unsustainable over the long term (graph 1).

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\(^1\) The current account regroups four very distinct components. The first involves merchandise trade balance. The second covers exported and imported services, which includes spending by tourists and transportation expenses. The merchandise and service trade balance are the essential elements of the current account, where the term trade balance is sometimes used to refer to the current account, and vice versa. The third component accounts for investment income, or the payment of interest or dividends between countries. Lastly, the current account also includes net unilateral transfers, or international payments that are not used to buy any goods, services or assets, but for things such as donations.

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Today, nothing suggests that consumers—especially in the U.S.—are ready and willing to embark on another spending spree. Consumers will be even more cautious, especially since it will take several more years to clean up the damage left by the collapse of the real estate bubble on personal and family balance sheets. More specifically, at the peak of this crisis, total losses exceeded more than US$17,000B for all U.S. households (graph 2). The higher savings rate (graph 3) and the rebounds in stock markets over the past year have restored only a fraction of the wealth lost, or about US$5,700B. What remains clear is that global economic growth will have to count on a new dynamic to post sustainable growth in the medium term.

PUBLIC DEBT MUST BE BETTER CONTROLLED
Secondly, the next few years will be marked by the stabilization of public finances. Despite the lengthy period of prosperity, several governments have accumulated deficits in the past few decades while their debt levels spiralled upwards (graph 4). The recent recession has, as a result, seen the public debt of several countries balloon to over 90% of GDP, the level at which some studies suggest the negative collateral effects start to be felt. These repercussions can also cut the economy’s pace of growth by 1% on average annually (table 1 on page 3). This slowdown in growth could stem from an increase in interest rates or taxation rates, among other sources. Some countries, especially Greece, are already having great difficulty refinancing their loans. Portugal’s sovereign debt was downgraded in March 2010, and several other countries may suffer the same fate at the hands of credit rating agencies.

GLOBAL TRADE CANNOT CONTINUE TO OVERLOOK THE SAME COUNTRIES INDEFINITELY
Thirdly, countries cannot post current account deficits indefinitely. Yet this is what has happened in the United States since the start of the 1980s (graph 5 on page 4). The situation even got worse at the beginning of the new century due to the rapid growth of imports over exports. On average, between 2001 and 2008, the U.S. trade deficit was almost equal to the surplus of the rest of the world’s countries, combined (graph 6 on page 4).

In the current context, heavily-indebted governments have few options. In the short term, slashing spending quickly or raising taxes sharply would only compromise the recovery. However, sitting on the sidelines while deficits continue to mount could have lasting financial consequences over the longer term (drop in credit rating and higher interest rates) which could also slow economic growth. A compromise is within reach, however: applying measures gradually to stabilize public finances.

Policies in certain emerging countries that boost exports by suppressing the value of their currencies vs. the U.S. dollar will...

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have also contributed to the trade imbalance. In other respects, commodity-exporting countries, those that have benefited from increased prices for their exports for the past 10 years or so, saw their trade balances improve almost automatically. For the commodity-importing countries, like the United States and their imported oil, price increases usually come with the requisite deterioration in the trade balance, unless import volumes are reduced significantly, which is quite rare. Moreover, domestic macroeconomic imbalances can also have a noteworthy impact on changes in the trade balance.

**IMBALANCES THAT ARE NOT MUTUALLY EXCLUSIVE**

There is a relationship between trade imbalances, excessive household consumption and government debt. All things
being equal, any country where households and the government are heavily-indebted is bound to see its current account balance deteriorate. In fact, according to economic theory, the current account balance can be seen as the equivalent of foreign capital flows. When local savings are insufficient to finance excess household and government debt, a net inflow of foreign capital is needed to balance everything (see box 1 on page 5). The level of investment can also have an impact on foreign capital flows. Rising investment can increase the need for capital, while lagging investment reduces this need. It is widely acknowledged, however, that resorting to foreign capital to finance investment (in the public and private sectors) is less of a problem since this foreign capital contributes to increasing the potential for economic growth.

This way of linking trade imbalances with an economy’s domestic macroeconomic imbalances does not brush off the way exchange rate policies hold sway. When a country sets its exchange rate at a level that is too low, the low prices for goods paid by foreigners in their national currency encourage excessive consumption (drop in savings, increase in foreign capital needs). Moreover, in some cases these policies have had a noteworthy impact on interest rate shifts in the importing countries. The example that stands out the most is the case involving China. To keep its yuan at a low level, China has been stockpiling impressive foreign exchange reserves (graph 7). In practice, these assets are mainly U.S. securities. As a result, this additional demand for U.S. securities simply translates into lower interest rates in the U.S: an incentive in the vicious circle of indebtedness. However, the downward pressure on interest rates in the U.S. should ease up gradually now that central banks are diversifying their foreign exchange reserves in favour of other currencies, like the euro.

ONE OVERALL SOLUTION FOR SUSTAINABLE GROWTH

There is reason to believe that the conditions needed to foster sustainable growth will come together while avoiding any repeat of past excesses. However, it will still take a few years for this type of dynamic to settle in. To offset the weaker contribution from consumers in a number of industrialized countries, economic growth in these countries will have to rely more heavily on business investment and improving trade balances. In exchange, emerging countries—which already used to liquidate major portions of their output abroad—will have to rely more on domestic growth by stimulating consumption and investment (graph 8 on page 6). Countries like China are expected to gradually stop controlling their exchange rates, which will make these adjustments easier.

In any event, some may have doubts about the anticipated strength of business investment, especially in industrialized countries, as consumption is expected to be moderate. Yet there are a number of arguments that lean in this direction. First, investment is a good way for a business to make sure it is competitive and maximizes its profits over the long term. Moreover, development in emerging nations will open new markets up. Also, opportunities are emerging locally, particularly in new technologies, the energy sector and, increasingly, in industries associated with the environment.
Box 1 – The current account seen from a different perspective

From an analytical standpoint, we can show that, for a given country, the current account balance fluctuates according to private savings, investment and public deficit.

First of all, let’s define what we mean by savings. A country’s savings (national savings) is derived from both individuals and businesses (private savings) and from the government (public savings). Private savings is the portion of income that is not consumed or used to pay taxes. Public savings is the difference between what the government spends and what it takes in. When the government posts a deficit, the public savings are in negative territory and vice-versa. The equation below sums this up.

\[ S = S_p + S_g \iff S = (GNDI - C - T) + (T - G) \]

Where:
- \(S\) means total savings for a country
- \(S_p\) means private savings
- \(S_g\) means public savings
- \(GNDI\) means gross national disposable income
- \(C\) means consumption
- \(T\) means taxes
- \(G\) means government spending

To link savings with the current account, we start with the baseline equation showing the equality between an economy’s income and expenses, or \(GNDI = C + I + G + CA\), where “\(CA\)” is the current account balance and “\(I\)” is investment.

By moving the terms of this equation around, the result is as follows: the current account balance is equal to income minus consumption, minus investment, and minus government spending.

\[ CA = GNDI - C - I - G \]

Using the savings equation, we can replace \(GNDI - C - G\) with the national savings or “\(S\).” With this equation, we find that a country’s current account balance is based on the difference between national savings and investment.

\[ CA = S - I \]

In other words, if investment is higher than savings, the country must borrow internationally to finance its current account deficit. Conversely, if a country’s investment is lower than its savings, the country will lend its surplus savings to other countries. Breaking national savings down between private savings and public savings gives us the relationship between the current account, private savings, the public deficit and investment.

\[ CA = S_p + S_g - I \]

This last equation shows us that when a government does not do a good job of controlling its spending (i.e. negative \(S_g\)), this has a negative impact on the current account balance. In the same way, excess consumer debt reduces private savings (\(S_p\)), thereby emphasizing the need for foreign capital.
Lastly, access to financing will be bolstered by households’ high savings rates and the downside pressures that this should put on the market’s rising interest rates. A reduction in public deficits would also be of good help for businesses’ credit conditions.

Economic growth that is sustainable is essential for Western governments to get back to balanced budgets, and these governments were hard hit the most throughout this recent recession. If the private sector failed to bounce back, it would be hard for governments to wind down their economic support. To avoid compromising the economic recovery however, the best solution is to gradually restore the budgetary balance while implementing the conditions that favour making productive investments (in the public and private sectors) and developing human capital. These measures would increase the economy’s potential growth, which would in the long run contribute to reducing the weight of the debt vs. the size of the economy.

Lastly, some countries will benefit from rising revenues generated by commodity price advances that should continue in the medium term. In Canada, this factor provides strong support for domestic demand (graph 9). On the other hand, the exchange rate tends to reflect increases in the terms of trade which works against other sectors of activity. The expression “Dutch Disease” is often used to describe this phenomenon. Here again, investment and innovation, which translate into gains in the area of competitiveness, are among the solutions to prevent declines in the industries hard hit by currency fluctuations.

CONCLUSION: THE GLOBAL ECONOMY NEEDS A NEW DYNAMIC

After many years of frenetic growth, the time has come to measure the many excesses that led to the downward spiral at the end of the first decade of the 21st century. The growth fundamentals of yesteryear, which relied mainly on the consumer—the U.S. consumer, in particular—are not viable over the long term. A new balance that calls for a better sharing of wealth will have to emerge. We have to prevent the industrialized countries, and the emerging economies, from being confined to extreme positions that simply create new global imbalances.

Will 2010-2020 be the decade of “rebalancing”? For this to occur, we have to get down to defining the new support parameters for the global economy. On this topic, the emerging countries will have to put greater emphasis on growing their domestic demand while this demand in the U.S and in other industrialized nations will be reined in due to efforts to stabilize household and government balance sheets. Businesses, through investment and innovation, will be called upon to boost their contribution to economic growth in the short and long terms.

In fact, other imbalances could also shake the stability of the global economy. The risks brought on by the possible bursting of the credit bubble in China due to the high volume of dubious quality loans granted by financial institutions (graph 10 on page 7) or, closer to home, if the Dutch Disease in Canada’s economy intensifies due to a new surge in the loonie’s value.

Be that as it may, we do not need to recreate the situation that prevailed before this recession. Worsening household debt would only increase the risk of a second financial crisis.
requiring a new round of government intervention. Conversely, worldwide demand for credit cannot remain moderate for too long either, since this would require governments to prop up their economies for longer periods than expected, similar to what’s been taking place in Japan for the past 20 years (graph 11). Used properly, credit plays a pivotal role in economic development. However, capital allocation will have to be redirected toward productive investments and innovation to allow everyone to gain from genuine wealth creation and improve their standard of living.

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