

ADDRESSING THE PRESSING NEED TO REDUCE GLOBAL AND EUROPEAN IMBALANCES

Joint FEPS-CDPR Publication

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In examining global imbalances, this Policy Brief focuses on projected trends over the next ten years in two key economic variables: GDP growth rates and current-account balances as a ratio to GDP.

At the global level, it examines these two variables for the four most economically important countries/blocs: the USA, Japan, the People's Republic of China and the European Union.

Within the European Union it focuses on the same variables for the Core Eurozone (which groups together such countries as Austria, Germany and the Netherlands), the Eurozone Periphery (which groups together such countries as Greece, Italy, Portugal and Spain) and the two major countries of France and the United Kingdom.

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Introduction

This Policy Brief is focused on the need to reduce macroeconomic imbalances both globally and within Europe. In doing so, it employs the CAM global macroeconometric model to make projections of trends over roughly the next ten years, i.e., through 2025.

This effort follows the pattern established in previous joint FEPS-CDPR Policy Briefs. These have included Policy Briefs disseminated in August 2013 and November 2014, which have been published by the Foundation for European Progressive Studies.

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The Baseline Scenario: Global Imbalances

As in past efforts, we compare the results of a 'Baseline' Scenario (in which we assume minimal changes in policy) with an 'Alternative' Scenario (in which we explicitly program a set of progressive policy changes).

In view of the current crisis involving Greece and, more broadly, the continuing stagnation in economic growth and the heavy debt burdens of many countries within the European Union, the programming for our 'Alternative' Scenario might look exceedingly ambitious. Yet its guiding motivation is to identify what 'realistically' has to be done in order to set Europe, as well as the global economy, on a more sustainable economic trajectory.

At the end of this Policy Brief we will review the effects of these two scenarios on the debt burden of the Eurozone Periphery. Even under the Alternative Scenario this burden would remain onerous: the debt stock would still stand at about 140% of GDP. Hence, debt relief (not just restructuring) should have been a central component of any EU-wide programme to prevent Greece from defaulting and allowing it to remain a viable member of the Eurozone.

We start our Policy Brief with a description of some of the important economic trends projected by our Baseline Scenario. Table 1 examines the trends in the current account as a percentage of GDP for our four key countries/blocs at the global level.

It lists historical statistics for 2000, 2007 and 2014, which are provided by the statistical base of the CAM model. Then it lists the projected estimates of the current account as a ratio to GDP for the period 2015-2025. This projection is generated by the CAM model and is known as the Baseline Scenario.

This scenario essentially carries forward the basic thrust of historical trends and established policies. The latter includes, for example, continuing reductions in both government expenditures and

revenue. But it should also be noted that for the European Union it includes the additional assumption of a mild stimulus to investment, which has been advocated by the recent Juncker plan.

Table 1 shows that according to the Baseline Scenario there is likely to be an improvement in the previously high current-account surpluses in China. While China's surplus was an astounding 9.6% of GDP in 2007, it had already been reduced dramatically by 2014 to 1.9%.

The CAM projection suggests that its current account will drop further, to 1.5% of GDP by 2025. This lower level of surplus is tied to China's increasing dependence on energy imports since its domestic production of energy is projected to be outstripped by its energy demand.

Table 1. Current Account (% of GDP), Historical and Baseline Projection

	Historical			Projected
	2000	2007	2014	2025
China	2.0	9.6	1.9	1.5
European Union	0.6	-0.5	1.9	1.3
Japan	2.7	4.5	0.7	3.8
United States	-3.7	-5.1	-2.3	-4.7

In contrast, current-account imbalances are projected to worsen appreciably in the USA and Japan. For example, Japan is likely to re-establish the large current-account surpluses that it exhibited before the global financial crisis. For instance, in 2007 its surplus was 4.5% of GDP.

Our projection suggests that Japan's surplus will rise from a fairly low level in 2014 to reach 3.8% by 2025. Its surplus will also be matched by sizeable future surpluses throughout the rest of East Asia.

The USA will have the opposite problem. In 2007 its current-account deficit, as a ratio to GDP, was an alarming -5.1%. The ensuing recessionary conditions from 2008 onwards helped to moderate this deficit, reducing it to -2.3% in 2014. But its future deficit is projected to rise dramatically, reaching an ominous -4.7% of GDP in 2025.

The current account for the European Union has been in surplus since 2007, reaching 1.9% of GDP by 2014. This has been due primarily to the large surplus created by Germany and secondarily by some small surpluses created in the Eurozone Periphery, largely brought about by the depression of domestic aggregate demand.

The Baseline Scenario suggests that the current account surplus for the European Union as a whole will moderate in the future. In 2025, for example, it will stand at 1.3% of GDP. However, this aggregate result does not reveal the state of the imbalances *within* the European Union.

Hence, despite some apparent improvements, current-account imbalances will continue to be a problem for the global economy in the future. The seemingly precarious financial position of the USA (even though it will still be the world's leading reserve-currency country) is particularly problematic.

The Baseline: Global Trends in Economic Growth

The problem of global imbalances is likely to be compounded by pervasively modest rates of global economic growth over the next ten years. For China, the European Union, Japan and the USA, **Table 2** provides the average historical growth rates for 2000-2008 and 2009-2014 and the average

projected growth rate over 2015-2025. The table also provides similar statistics for the global economy as a whole.

The CAM projection is fairly optimistic about China's economic growth in the future. It estimates an average rate of 8% (higher than most current predictions). But across the European Union, Japan and the USA, growth rates are projected to be well below 2%.

While such averages represent an improvement over corresponding historical statistics for the 2009-2014 period of recession and stagnation, they are still below the higher rates that these blocs experienced during 2000-2008, i.e., before the global financial crisis.

Table 2. Average GDP Growth Rate, Historical and Baseline Projection

	Historical		Projected
	2000-08	2009-14	2015-25
China	10.5	8.8	8.0
European Union	2.5	0.2	1.6
Japan	1.5	0.3	1.1
United States	2.6	1.2	1.4
Global	3.4	2.0	2.7

The relatively slow growth rate that the CAM projects for 2015-2025 for the USA (namely, only 1.4%) is particularly worrying, especially since it is currently being touted as one of the main engines for global growth. Its projected growth for the next decade would be, for example, well below its 2.6% average growth during 2000-2008.

There is projected to be a similar problem for both the European Union and Japan. The EU's projected growth rate during 2015-2025 would be only 1.6% whereas the corresponding rate that it achieved during 2000-2008 was 2.5%.

Hence, despite the anomaly of the projected robust growth maintained by China, the global economy is expected to grow by only 2.7% over the next ten years. While certainly a welcome improvement over its relatively low 2% growth rate during 2009-2014 (in the wake of the global financial crisis), the rate achieved by the global economy during the earlier period of 2000-2008 was a much healthier 3.4%.

The quick review above of the continuing current-account imbalances and relatively slow economic growth that the CAM projects for the next ten years suggests that policymakers need to prioritise identifying policy alternatives that could substantially improve conditions in the global economy as well as within major regions and countries. Our particular concern is identifying policies that could improve economic conditions within the European Union.

Framing an Alternative Policy Scenario

In order to frame an alternative policy scenario that could significantly improve on the unsatisfactory projected outcomes from the CAM's Baseline Scenario, we program changes in a number of important policy variables. This set of changes will frame the basis for projections by an Alternative Scenario, both for the global economy and for blocs and countries within the European Union.

Primarily for countries in the European Union but also for the USA, we set floors on the reduction in government expenditures as a ratio to GDP. For the most part, these floors are designed to maintain current post-crisis levels of public expenditures. Without them, austerity measures (such as the currently planned radical cuts in welfare in the United Kingdom) would intensify the downward pressure on aggregate demand.

In the Eurozone Periphery, however, we assume—as a minor boost to aggregate demand—a small increase in the level of government expenditures. Though this is meant to be a counter-weight to continuing austerity, the resultant level will still be well below its historical peak before the global financial crisis.

Setting such floors contrasts with the Baseline Scenario, under which government expenditures are projected to continue declining, contributing thereby to further economic stagnation.

As mentioned earlier, the Baseline Scenario already incorporates modest increases in investment in the European Union, which are modelled on the Juncker plan. In contrast, the Alternative Scenario programs significant additional increases in investment.

Within Europe, the aim is to increase investment to 20% of GDP—such as in France, the Core Eurozone and even in the Eurozone Periphery. In the United Kingdom, where investment as a ratio to GDP has remained abysmally low, programming seeks, more modestly, to raise it above 18%.

Such a general initiative across the European Union could be financed by the European Investment Bank, which is able to issue bonds on the capital market for such purposes.

In Japan and the USA, the CAM programming seeks to increase investment as a ratio to GDP to 22%. Such programming should help drive increases in aggregate demand and, also importantly, boost aggregate supply and productivity.

Concomitantly, the Alternative Scenario programs a boost in private savings as a ratio to GDP in the USA, in order to counter the negative impact of excessive domestic aggregate demand on its large and growing current-account deficit.

However, in the Core Eurozone, where large current-account surpluses are the primary problem, a decrease in private savings (and a concomitant increase in consumption) is programmed. Such an increase in consumption could be driven by increasing wages, such as through government boosts to the minimum or living wage.

Lastly, in countries and blocs where current-account deficits pose persistent problems, the Alternative Scenario targets decreases in the nominal exchange rate, as a basis to bring down the real exchange rate.

This programming applies, within Europe, to France, the Eurozone Periphery and, especially, the United Kingdom. In the European Union quantitative easing by the European Central Bank has already begun to have such an effect across the Eurozone.

Central Banks or the Governments in the United Kingdom and the USA will have to devise measures to have a similar effect on devaluing the Pound and the Dollar, respectively. Both countries are facing the formidable threat of rising current-account deficits.

In contrast, where large current-account surpluses could pose future problems, such as in Japan and other countries in East Asia, the Alternative Scenario programs an increase in the real exchange rate. However, no targeting of the real exchange rate is applied to China since its current-account surplus is projected by the Baseline Scenario to remain historically low.

Alternative Scenario: Global GDP Growth

What is the effect of the policy-related programming outlined above? First, we review the projected outcomes for the period 2015-2025 for the global economy and major blocs/countries within it.

Table 3 shows the results, from both the Baseline Scenario and the Alternative Scenario, for the growth of GDP for the global economy and, within it, for China, the European Union, Japan and the United States.

Table 3. Average GDP growth, Baseline and Alternative Scenarios

	2015-2025	
	Baseline scenario	Alternative scenario
China	8.0	8.7
European Union	1.6	3.8
Japan	1.1	1.2
United States	1.4	3.4
Global Economy	2.7	4.0

While the projected growth of the global economy would be only 2.7% in the Baseline Scenario, it would rise to 4% in the Alternative Scenario. Benefiting indirectly from policy changes in other countries and blocs, China's GDP growth would rise marginally, from 8% to 8.7%. This would be aided mainly by increased growth in both its investment and exports.

In both the European Union and the USA (where the Alternative Scenario has concentrated its programming), economic growth would improve substantially. In the EU, growth would increase to 3.8%; and in the USA, it would rise to 3.4%. The projected results show that USA's growth would be prompted by a revival in government expenditures as well as significant increases in investment.

However, in Japan, despite the programmed changes in policy in the Alternative Scenario, the growth rate of GDP would barely budge, rising from 1.1% to only 1.2%.

In other words, its propensity to 'secular stagnation' appears to be impervious to the policy initiatives that have been programmed. The Scenario outputs show that during 2015-2025 Japan's growth rate of consumer expenditures would decline by half and investment would slow markedly later in the ten-year period.

Thus, even though some countries and blocs would improve their economic conditions and the global economy would grow much more quickly, problems would persist in Japan—and, arguably, in China as well since its continuing rapid economic growth (heavily dependent on investment and exports of manufactures) is not likely to be sustainable.

Alternative Scenario: Current-Account Balances

What is the effect of the programming in the Alternative Scenario on current-account balances for major blocs and countries across the globe? And how does this outcome compare to that for the Baseline Scenario?

For China, there appears to be very little difference across the two global scenarios (see **Table 4**). In the Baseline Scenario its current account as a ratio to GDP would be 1.5% by 2025 and in the Alternative Scenario it would be 1.3%. The main factor holding back an increase in its current-account balance is the rise in its deficit on energy, which would cancel out much of its continuing surplus on manufactures.

In the European Union there will also be a small decline in its aggregate current account. While in the Baseline Scenario its surplus would be 1.3% of GDP, in the Alternative Scenario it would be 1.0%.

Table 4. Current Account (% of GDP), Baseline and Alternative Scenarios

	2025	
	Baseline Scenario	Alternative Scenario
China	1.5	1.3
European Union	1.3	1.0
Japan	3.8	2.3
United States	-4.7	-3.7

In Japan, however, there would be a significant reduction in its current-account surplus under the Alternative Scenario. While its current-account surplus would be 3.8% of GDP under the Baseline Scenario, it would fall to 2.3% under the Alternative Scenario. In the rest of East Asia there would also be substantial reductions in current-account surpluses.

Importantly, the current-account deficit of the USA would also improve under the Alternative Scenario. While its deficit would be -4.7% of GDP in 2025 under the Baseline Scenario, this ratio would fall to -3.7% under the Alternative Scenario. This decline is projected to be aided by a diminishing dependence on energy imports.

Though there will not be a dramatic decline in the US deficit, this drop should still lead to a more manageable external position, which could have important concomitant benefits for the world economy as a whole.

The Impact on Europe of the Two Scenarios

In this section of the Policy Brief we compare the effects of both the Baseline Scenario and the Alternatives Scenario on blocs and major countries within the European Union. These include the Core Eurozone, the Eurozone Periphery, France and the United Kingdom.

Economic Growth

Table 5 shows the rate of economic growth for these four blocs/countries for the projected period of 2015-2025 for both the Baseline Scenario and the Alternative Scenario.

The Baseline Scenario projects that in the Core Eurozone (led by Germany) economic growth will achieve a 1.9% average over the next decade. In contrast, the Alternative Scenario projects a healthier average economic growth of 4%.

The differences in projections are similar for the Eurozone Periphery (led by Italy and Spain and including Greece and Portugal). While the Baseline Scenario projects only 1.2% average economic growth, the Alternative Scenario projects 4.1%.

Table 5. Average GDP growth, Baseline and Alternative Scenarios

	2015-2025	
	Baseline scenario	Alternative scenario
Core Eurozone	1.9	4.0
Eurozone Periphery	1.2	4.1
France	0.5	3.0
United Kingdom	1.4	3.6

There are also striking differences between the two scenarios on projections of economic growth for France and the United Kingdom. For France the difference is 0.5% versus 3% growth during 2015-2025. For the United Kingdom the difference is 1.4% versus 3.6%.

However, it should be noted that these impressive results are due to programmed policy changes not only within the European Union but also within other major countries within the global economy, especially the USA.

Current-Account Balance

Compared to the current-account balances projected for 2025 by the Baseline Scenario, those projected by the Alternative Scenario are mostly a clear improvement.

These differing outcomes are presented in **Table 6**. It shows that the Baseline Scenario projects stark imbalances within the European Union in 2025.

Table 6. Current Account (% of GDP), Baseline and Alternative Scenarios

	2025	
	Baseline scenario	Alternative scenario
Core Eurozone	5.6	1.8
Eurozone Periphery	-0.5	-0.1
France	-2.9	-1.8
United Kingdom	-7.0	-2.8

For example, the Core Eurozone would enjoy a current-account surplus of 5.6% of GDP in 2025 while the UK would suffer from an appalling current-account deficit of -7.0%. In 2014, in contrast, the UK's current-account deficit had been much smaller, i.e., -2.8%.

In addition, France would have to suffer from a current-account deficit of -2.9% under the Baseline Scenario. This would represent a discernible deterioration from its deficit of -2.2% in 2014.

In contrast, the Eurozone Periphery would have a current-account deficit of only -0.5% in 2025. But the chief explanation for this outcome would be its concomitant slow 1.2% rate of economic growth and the savage depression of its aggregate demand after the global financial crisis that had already painfully transformed its -7.6% deficit in 2008 into a 0.6% surplus in 2014.

The Alternative Scenario

The Alternative Scenario would have some notable successes in minimizing stark imbalances in the current accounts of countries and blocs within the European Union.

For example, in contrast to the large surplus of 5.6% in 2025 for the Core Eurozone under the Baseline Scenario, the Alternative Scenario projects only a 1.8% surplus. While the Core Eurozone would benefit from decreasing dependence on energy imports, the dramatic drop in its exports of manufactures would be the principal factor reducing its current account surplus.

Moreover, whereas the United Kingdom would have to deal with a daunting deficit on its current account of -7% of GDP in 2025 under the Baseline Scenario, it would face only a -2.8% deficit under the Alternative Scenario.

While the UK's surplus on the export of services would hold up, it would still have a deficit on energy and a sizeable deficit on manufactures. Nevertheless, its external vulnerability would still be more manageable under the Alternative Scenario.

France is also projected to enjoy a significant comparative drop in its current-account deficit in 2025, i.e., from -2.9% to -1.8%. The depreciation of the euro would certainly help but this trend would be aided by a significant decline in its deficit on energy.

Also, under the Alternative Scenario, the current account of the Eurozone Periphery would almost be in balance, at -0.1%. But its significant deficit on income and transfers (namely, about -2% of GDP) would continue. This would be offset, however, by continuing surpluses on manufactures.

So the current accounts within the European Union would become more manageable as a result of the Alternative Scenario. The deficits of France and the United Kingdom would be substantially reduced while the large surplus of the Core Eurozone (led by Germany) would markedly decline.

Concluding Remarks

This Policy Brief has used the CAM global macroeconometric model to program a set of policy initiatives that could address imbalances both in the global economy and in the European Union.

Our programming, which we have identified as an Alternative Scenario, has primarily involved setting floors on government expenditures, significantly boosting investment and targeting decreases in real exchange rates. This scenario has been relatively successful in reducing current-account imbalances while increasing the growth rates of GDP.

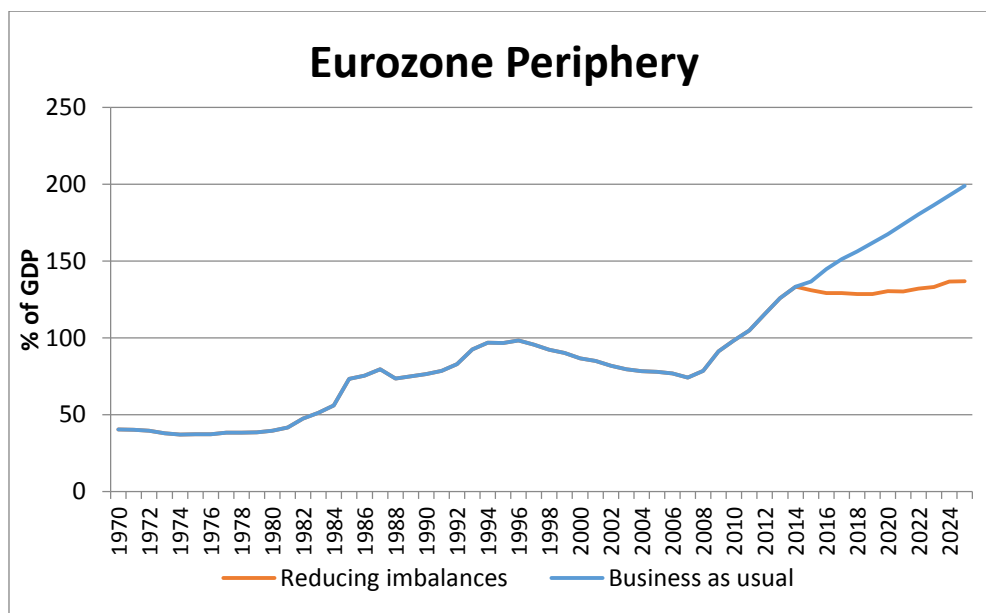
At the global level, GDP growth would remain high in China and increase significantly in the USA and the EU. But growth would still remain low in Japan.

Current-account surpluses would be only marginally decreased in China and the European Union. More importantly, the substantial surplus of Japan would be reduced and the perilous deficit of the USA (which could contribute to destabilizing the global economy) would be contained.

Within the European Union, the growth rates of GDP would increase significantly across the board, to 3%-4%. In contrast, under the Baseline Scenario growth rates would range only from 0.5% to 1.9%.

EU current-account imbalances would also be reduced across the board. In particular, the high 5.6% surplus of the Core Eurozone would be reduced to only 1.8%; and the perilously large -7% deficit of the United Kingdom would be reined in to a more manageable level of -2.8%.

Figure 1. Government Debt as a % of GDP: The Baseline and Alternative Scenarios



Yet it is important to note that the more favourable outcomes projected for the European Union would not have solved some of its more intractable problems. Figure 1 illustrates, for example, the results for the debt stock as a ratio to GDP for the Eurozone Periphery.

Under the Baseline Scenario, this bloc's debt stock would mercilessly and inexorably approach 200% of GDP by 2025. Clearly this would be a painfully unsustainable outcome. In contrast, under the Alternative Scenario, this ratio would stay below 140%. Though a significant improvement by comparison, this latter outcome would still not be favourable.

These results provide a useful perspective on the inability of the EU to address the most pressing problems of member states such as Greece. Continuing austerity would certainly not rectify Greece's problems, for instance. And even a significant upturn in economic growth would not suffice. Instead it is crucial that substantial debt relief is brought forward and put at the centre of any efforts to keep Greece solvent and a continuing viable member of the European Union.

In the midst of the grave crisis precipitated by Greece's understandable inability to repay its international debts, it is imperative that EU policymakers identify more ambitious and indeed more progressive solutions to the EU's current prolonged malaise. This Policy Brief has tried to make a modest contribution to the debate on how EU might begin to do so.