There's still room for improvement

Lower interest rates are not enough – central banks still need to resolve exchange rate and structural issues to spark a global recovery, says Giles Keating of CSFB.

Global action to lower interest rates has bought some relief to financial markets. Welcome as this is, it is not enough for a robust global recovery. Rather, it creates a brief opportunity to improve two other key areas.

First, exchange rates need to move back to more sensible levels, with the euro recovering somewhat, the yen remaining weak, and the net effect being some decline in the dollar from its increasingly destabilising trade-weighted highs. This process has tentatively begun with the US trade weighted index (TWI) falling from its high at the beginning of April.

Second, all key regions need to make real progress on their respective structural problems. If exchange rate misalignments and structural issues are not addressed, any recovery in both markets and the economy risk being aborted later this year.

The problem with three deficits

Since 1998, there has been a substantial worsening in what we call the three deficits: the current account deficit in the US, the fiscal deficit in Japan, and the productivity deficit in Europe. These long-term problems are compounded by a series of shorter-term developments which in recent months have seen the world economy move away from stable equilibrium and towards a more dangerous path: still-high oil prices, lower consumer confidence, an overhang of technology inventories, and misaligned currencies.

Rate cuts, including ECB action, are helping, perhaps generating a gradual recovery in US and then global growth starting some time in the third quarter. But this would be more of a 'U' than a 'V' shaped recovery, and the overall upswing is likely to be more hesitant and less robust than its predecessors, for reasons not directly susceptible to monetary stimulus.

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The problem is the three deficits. Nations have not been competing for international capital flows on the basis of excellence in their policymaking. Instead, they have been acting as a cartel, able to pursue unsatisfactory policies because others are also doing so, leaving investors with nowhere to go. The scale of these deficits is substantial. The US current account deficit reached 4.6% of GDP in the fourth quarter, up from 1.7% just before the Asia crisis in early 1997.

Giles Keating

This figure is larger than anything ever seen before and seems particularly anomalous given the dollar's strength.

The Japanese fiscal deficit is expected to be in excess of 7% of GDP in the upcoming fiscal year and the resultant debt to GDP ratio is now 130% of GDP and rising rapidly. In Europe, productivity has failed to show any sign of acceleration. Our analysis indicates positive indicators for the future, such as higher technology investment, but this remains balanced by negative ones, such as the slowness of labour reform.

Turning point

During their build-up over the past three years, these three deficits actually helped to enhance perceived economic performance.

The capital inflows that financed the US external deficit flowed to consumption and investment. Europe's poor productivity performance ensured a weak euro, which underpinned corporate profitability and helped provide the stimulus for falling unemployment. Japan's rising government debt financed public works, taking the edge off the economic weakness, which would otherwise have been even more severe.

But a turning point now appears to have been passed, at which the benign process of build-up is coming to a more or less forced end and the consequences of sorting out the deficits need to be faced.

In the US, symptoms include the fall in consumer confidence and the cut-back in corporate investment plans (particularly in the technology sector).

In Japan, it is the soaring savings ratio, which now seems likely to neutralise at least fully any further expansion of the fiscal deficit. In addition, in Europe, it is the relative softness of the euro, despite a growth rate running, at least on a quarterly basis, substantially higher than that of the US. This difficult environment calls for a somewhat different style of policymaking and policy presentation, compared with previous years. Three areas are crucial:

- first, central bank action has to be more flamboyant, to underpin confidence. The size and timing of the Federal Reserve's rate moves and the adoption at last of quantitative easing by the Bank of Japan fit this pattern. Now the ECB needs to demonstrate similar flair;
- second, more appropriate exchange rates are urgently needed. The euro has to strengthen. The yen needs to stay weak, and the net effect should be some decline in the dollar's trade-weighted rate; and
- last, there must be appropriate structural action. In the US, this means tax cuts designed to help the private sector re-liquify and re-build damaged balance sheets, rather than a short-term stimulus to spending. In Japan, fiscal tightening now seems more likely following the change of leadership. It looks as though this may be presented in a confidence-enhancing way, as part of an overall package of reconstruction of financial sector balance sheets, and reform of the old-style public works spending.

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The benefits for the financial markets and the global economy from the current round of monetary easing will be durable only if all of these areas are convincingly addressed in the coming months. ■

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