# Rebalancing the Global Economy: A Primer for Policymaking

Edited by
Stijn Claessens, Simon Evenett
and Bernard Hoekman


A VoxEU.org Publication

CEPR

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# 20 Rebalancing will require supply side policy changes, but pitfalls abound

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*Much of the debate over global imbalances has focussed on the demand side. This chapter argues that rebalancing national economies should not overlook the contribution that supply side factors can make. Nevertheless, it warns that any rebalancing imperative may well be hijacked by governments to advocate policies that promote certain sectors over others, which will inevitably foster international trade conflicts.*

All too often, the rebalancing of national economies is treated foremost as a demand side challenge. Appealing to national income accounting, every economics student knows that narrowing the current account requires steps to reduce the gap between total national savings and national investment. One component of the former is the government's budget deficit which, depending on your view of macroeconomics, may be determined by aggregate demand management policies. Investment expenditure is said to be an expectations-driven factor, influenced by optimism about future economic performance. Deficit countries need to cut government spending, raise taxes, fund more private sector investment themselves (or forgo that investment) if current account imbalances are to be fall. Is there no role, then, for supply side policies to contribute to rebalancing?

We argue that rebalancing national economies should not overlook the contribution that supply side factors – many of which, for better or for worse, are amenable to government policies – can make. In one respect certain policymakers are already ahead of the analysts. For instance, senior members of the outgoing UK Labour Government had made the link between that country's trade deficit and the need (in their view) for reindustrialisation and, ultimately, for a new batch of industrial policies.[1] Coming on top of the slew of state measures that discriminate in favour of industrial firms taken by many governments during the

1 Such was the apparent openness to new ideas that Lord Mandelson, a leading figure in the UK administration of Gordon Brown, argued that there were lessons the UK could take from French experience with industrial policy. While the new UK government has yet to express itself fully on the matter of industrial policy Lord Mandelson's successor, Dr. Vincent Cable, was careful not to rule out such initiatives in his first major speech.

recent global economic downturn, rebalancing may well give industrial policy a new lease of life – hence the reference to pitfalls in the title of this chapter.

There are clear links and some differences between the arguments made in this chapter and elsewhere in this volume. Both Lim and di Mauro and Forster argue that supply side considerations influence current account imbalances. Lim argues that government ownership of leading firms in East Asia affected the level of corporate savings and, effectively, influenced national savings behaviour and hence accounted, in part, for the growing imbalances of recent years. By contrast, di Mauro and Forster argue that improving competitiveness in the Eurozone would go a long way to redressing Eurozone imbalances. Policies that promote innovation and competition between firms, they argue, are part of the rebalancing package. For their part, Kowalski and Lesher argue that commercial policy changes can facilitate rebalancing. If these arguments are right, then they too question the wisdom of viewing rebalancing purely through a demand management lens.

## Beyond expenditure switching and expenditure reducing measures

Reducing imbalances is often regarded as a matter of switching and, in some cases, reducing different components of national expenditure, implicitly keeping the focus on the demand side. But most of the relevant decisions taken by the private sector or the public sector are likely to be affected by supply side factors in the markets in question. Moreover, the impact of government measures to reduce imbalances may well be a function of those supply side factors.

For example, it may seem "obvious" that increased tax breaks for individual savings are needed in countries with large current account deficits. But private individuals are less likely to respond to such tax breaks if – based on previous experience – they believe that any tax advantages will be principally absorbed by an oligopolistic personal finance sector in terms of higher charges. Furthermore, given the legacy effects of prior malfeasance by firms in the personal finance sector (e.g. the UK pension "mis-selling" scandal) on the willingness of individuals to save, it should be little surprise that the personal savings rate is only marginally affected by tax changes.

There are at least two responses to the last example. The first response might be to argue that the state employ a measure that doesn't run into the same supply side constraints – assuming one exists. In the case of promoting private sector savings this might involve the adoption of draconian measures, such as mandatory personal savings regimes. The second, and perhaps more palatable, alternative is to argue that a longer-term fix for rebalancing requires state measures that eliminate pertinent supply side deficiencies as well as expenditure-influencing measures. This is because those very deficiencies may well have contributed substantially to the "under-saving" and, therefore, to the current account deficit, in the first place.

Pursing this logic further requires a government to identify to what extent private sector savings and investment decisions (and in principle, the government budget deficit) are influenced by the organisational-, entry-, competition-, and possible ownership-related bottlenecks of relevant markets. Without successful identification and remedy of the latter supply side constraints, surely questions will arise as to the likely success of any package of rebalancing measures.[2]

## Rebalancing and reindustrialisation: The slippery slope.

As a share of national spending, the shifts in expenditure needed for some countries to bring their current accounts into balance are significant. For deficit countries, some have argued that rebalancing should not require curtailing consumption, but rather the expansion of national output. What's more, many making such claims make the case for reinvigorating manufacturing industry. All too soon, such "logic" links rebalancing to reindustrialisation and to policies to promote certain sectors over others.

Concerns about deindustrialisation and appeals for national industrial policies are not new. What is of interest here is that they may be given a new lease of life by the attention given to rebalancing national economies. As acute readers have already noted, rebalancing in a country with a deficit country requires an expansion of national output (that other things being equal increases national savings) and that increase in national output could take any form, not just manufacturing. Rebalancing does not provide a justification for favouring manufacturing per se.

Still, governments may face significant political and corporate pressure to follow activist policies to shift resources into certain sectors, including manufacturing. In such a case, we may see rebalancing used to justify the mother of all sectoral policies. Worse, given the state measures adopted during the recent global economic downturn, governments may well be stumbling into policies of widespread cross-sectoral discrimination. What does the record say?

The precedent of adjustment efforts during the Great Recession does not augur well for the new discussion of rebalancing. Despite a relatively benign trade environment (albeit by contrast with the admittedly low standard of the dramatic growth in protectionism in the 1930s), Baldwin and Evenett (2009) have argued that in the recent global economic downturn there has been a rise in "murky protectionism." As they note, in addition to the usual raising of tariffs, quotas, and subsidies that often accompany economic downturns, governments have been using health and safety standards, "buy national" provisions, and "green policies" to boost their domestic economies – but often in a hidden discriminatory manner that on the surface are consistent with their formal WTO obligations, but hardly with its intent.

2 Lim's analysis in this volume is a case in point. If government ownership of many firms in East Asia accounts in large part for those firms saving more than they would have done had they been privately owned, one must wonder how effective any East Asian government policies' towards rebalancing must be if they solely focus on altering the behaviour of individual private savers (assuming measures for corporate savers are off limits).

In previous work, we have systematically analysed if countries are indeed using the financial crisis as an excuse to promote some type of "new industrial policy" that will give their firms an advantage (Aggarwal and Evenett 2010). Our findings are a cause for concern. The analysis we have conducted is based on the Global Trade Alert (GTA) database, which at the time consisted nearly 800 investigations of state measures that have been announced or implemented after the first crisis-related G20 summit in November 2008.[3] Based on our statistical analysis using proxies for pre-crisis intervention and comparing them to current intervention efforts in manufacturing, we found that pre-crisis measures of trade policy stance can account for only a sixth of the crisis-era discrimination in the Asia-Pacific region and just over a quarter of such variation in the non-Asia Pacific region.

Put differently, these findings suggest that "business as usual" –at least as seen as state favouritism along the lines of defensive trade policy considerations – cannot satisfactorily account for all of the crisis-era protectionism. Instead, the current crisis appears to have been motivated by other considerations. These motivations include the desire to promote new growth poles as well as environmentally-friendly technologies (so-called green industries) in addition to traditional protectionist responses.

In reality, we can envisage four forms of government bias towards sectors (see Figure 1). As will become clear, once rebalancing is introduced as an argument, in most cases it reinforces the case for sectoral discrimination. On the X-axis, we consider the sectoral objective being promoted by the policy. On the Y-axis or vertical dimension, we identify the force lobbying for sectoral discrimination: governments or firms.

In some countries, relatively inefficient firms have been actively lobbying for government action, with good examples being the General Motors and Chrysler in the US. These measures have protectionist elements, as helping failing industries through financial aid obviously distorts competition. Such lobbying has also been taking place among European firms as well. Also, in typical US fashion of defending old industries, firms receiving protection in the US include restraints against Chinese chicken imports and switchblades. In all of these cases, as output expansions can be argued (ceterius paribus) to increase national income and savings, then this form of discrimination is not on the face of it inconsistent with rebalancing.

3 Each investigation report identified the trading jurisdiction responsible for the announcement or implementation of the measure, a description of the measure (plus sources), and an evaluation as to whether the measure introduces, eliminates, increases, narrows, or otherwise changes any asymmetric treatment between domestic and foreign commercial interests. A traffic light system was used to distinguish between measures that do not change or improve the relative treatment of foreign commercial interests, that might disadvantage foreign commercial interests, and that almost certainly discriminate against foreign commercial interests.

In addition, each investigation of a state measure in Global Trade Alert identifies those economic sectors that are likely to be affected by a state measure. Details about a state initiative that are in the public domain are sought to identify the sectors affected. This assessment is conducted in a conservative manner. Indeed, if anything, there may be a tendency to under-report the number of affected sectors. The United Nations' CPC scheme for classifying economic activities (both goods and services) into sectors is employed.

Figure 1: Categorising the Motivation for Discriminatory Sectoral Policies[4]

| Sectoral Objective | | |
|---|---|---|
| ***Driving force*** | **Defense of declining or impaired sectors** | **Promotion of new products and services** |
| **Firm–led measures** | US and European auto sector, agriculture, insurance, banking | Educational services, carbon tax |
| **Government–led measures** | Banking | Fuel efficient autos (US), IT, wind turbines (PRC) |

A second type of pressure for sectoral discrimination is from firms that are innovating new products to restrict competition as they attempt to develop their goods and services. One significant example of this is the heavy lobbying by American and European firms to institute unilateral tariffs on countries that have not agreed to cap-and-trade controls in connection with the effort to limit greenhouse gases. Worse, to the extent that promoting new products is seen as contributing to national innovation and output expansion, it could be sold as a contribution to rebalancing too.

Governments have also taken their own initiatives, as in the extensive US and European aid to the financial sector. Although clearly lobbied for by banks and other financial enterprises, many of the measures undertaken by governments have been developed and promoted by government officials themselves with an eye to mitigating the effects of banks failures on the real economy. In this instance sectoral discrimination may not sit well with rebalancing national economies, in particular if banking and financial sector innovations have induced lower national savings rates.

Finally, there may be state-led efforts to develop nascent industries through restrictive measures. Although many analysts are rightly sceptical of the efficacy of industrial policy efforts, companies that actually have to deal with state-supported competition are often concerned with unfair competition – and may tie arguments for discrimination with those for rebalancing. In the recent global economic downturn, for example, the "green" measures being pursued by the Chinese government have little to do with coping with the financial crisis and much to do with state-led capitalism.[5] Any rebalancing imperative must not give such measures a new lease of respectability among policymakers.

4 See Aggarwal (2009) for a more detailed discussion.

5 The Chinese have been shielding their clean energy sector from competition to develop their own domestic firms, using government procurement to favour their own firms, and banning wind turbines with a capacity less than 1,000 kilowatts as a means to undermine the competitive position of European exporters of the most popular 850 kilowatt design. Chinese complaints about carbon tariffs in view of their own industrial policy efforts are less convincing in this light.

## Implications for policymaking

It is because circumstances differ so markedly across national economies – and so the proper mix of policies to support rebalancing are likely to vary too – that the purpose of this volume is as much as to highlight the relevant factors that policymakers must consider when formulating national, regional, and multilateral responses, as it is to hone in on the best policy for any one specific case.

In this chapter we have emphasised that it would be a mistake to think of rebalancing solely in terms of altering the level and composition of aggregate demand within an economy. For various reasons given here, supply side considerations are important as well, not least in conditioning how measures to affect demand actually alter market outcomes and national economic performance.

Macroeconomic fixes, then, may not be enough to deal with the longer-term causes of global imbalances. This is not to imply that the relevant "fixes" are easy to pull off, as there may well be substantial domestic opposition to the associated policy changes by vested interests. Rather, it is to suggest that the very interests that account for some supply side distortions (e.g limited competition among firms in the personal finance sector) in national economies may well be contributing to the growth and persistence of current account imbalances. Thus, a comprehensive approach to tackling those imbalances will require fixing those supply side distortions and ultimately taking on the vested interests concerned. This challenge may not be as daunting as it appears at first because governments can sequence their initiatives to reduce current account imbalances, confronting different interested parties as different times.

Finally, there is a risk that any rebalancing imperative will be inappropriately hijacked to advocate policies that promote certain sectors over others. Worse, such hijacking could extend the operational life of industrial policy measures put in place during the recent global economic downturn for which there was only a narrow interest group rationale. It is important for policymakers to remember that expanding one sector often comes at the expense of the contraction of another, providing little up front confidence as to how the gap between national savings and investment will change (the latter being the key determinant of imbalances.) Even when the expansion of a sector does not draw resources out of another sector, policymakers should satisfy themselves that there are no other knock-on effects of promoting the sector in question and that there is every reason to believe that the economy will move closer to current account balance. The evidential bar for sectoral policy advocates should, therefore, be set correspondingly high. Without such care, the rebalancing imperative will likely lead down the slippery slope to further state favouritism that will inevitably foster international trade conflicts.

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