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Treasury Committee

Global Imbalances

Tuesday 6 September 2011

Mr Jim O'Neill and Dr Gerard Lyons

Evidence heard in Public Questions 1 - 30

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 6 September 2011

Members present:

Mr Andrew Tyrie (Chair)

Tom Blenkinsop

Michael Fallon

Mark Garnier

John Mann

Jesse Norman

Mr David Ruffley

John Thurso

Examination of Witnesses

Witnesses: **Mr Jim O'Neill**, Chairman, Goldman Sachs Asset Management, and **Dr Gerard Lyons**, Chief Economist and Head of Global Research, Standard Chartered, gave evidence.

Q1 Chair: Thank you very much for coming to see us this morning. We have what appears to be a relatively quiet session-but not really a relatively quiet subject, all things considered. There seems to be quite a lot going on in this field.

I would like to begin by asking Dr Lyons whether he thinks that global imbalances were responsible for creating the conditions, or partly responsible for creating the conditions, that led to the crisis that we have just been through for the past three and a half years, and, if so, whether he thinks those conditions still pertain or whether public policy is addressing them.

Dr Lyons: Good morning; it is a pleasure and honour to be here. In answer to your question, I do not think global imbalances were fully responsible, but they were partially responsible for the financial crisis of the last few years. To put it in context, I think there were other factors, some of which might have been more important. I think a combination of factors came together: systemic failure in the financial system; inappropriate macroeconomic policies; a failure to heed the many warning signs; plus global imbalances. So global imbalances, naturally, did play a part. The challenge, of course, is quantifying what part they did play. In qualitative terms, we can say they were important-how important is difficult to ascertain fully.

In terms of the second part of your question, I don't think they are fully addressed at the moment and I think they do need to be addressed. In terms of moving to a balanced global economy in the future, I think we need to see global imbalances addressed and that, in my view, has three different parts to it. First, it means the deficit or debtor countries, which include the UK, getting their balance sheets back into shape and effectively changing the structure of their economies so that in future the debtor countries don't have to rely on debt to be the main driver of growth.

Effectively, the first part of restoring imbalances is the debtor countries need to spend less and save more. The second aspect, which is probably the most controversial, is that the savers need to do the opposite-spend more and save less. Among the savers I would include Germany, Japan, the Gulf countries and China. Now the challenge is why they should change policy to suit the global picture. Some of them will naturally spend more to suit their own selves. The third factor of addressing the imbalance is the whole currency issue, which has been part of the G20 agenda this year. So in terms of the second part of your question, I think there are different aspects to addressing the imbalances issue. I think they are only partially being addressed and I do think there is a lot more that needs still to be done.

Q2 Chair: Do you think these imbalances are inevitable to some degree as countries have different levels of productivity and different behaviour patterns with respect to savings and investment? Are we not, therefore, in a way just putting a finger in the dyke of the inevitable international adjustment that cannot be done without some abrasiveness?

Dr Lyons: Yes, I think that is partially correct. I think we should accept that it is not necessarily right, and it certainly would be wrong to expect the global economy-indeed, any individual economy-to be balanced all the time. Indeed, we might not always, as I stressed, want that to be the case.

Part of the problem in terms of imbalances has been both the scale and the concentration of these imbalances. That, I think, led to imbalances playing a part in the build-up towards the financial crisis. So those issues themselves need to be taken on board. On top of that, the question is when you look at imbalances I think it is important to put it in the overall context of whichever economy one is looking at. So imbalances can sometimes be good things if they are reflecting much stronger investment, much stronger potential for future growth. They can, however, be a bad thing if they are reflecting a build-up of debt that is driving domestic consumption that might be unsustainable.

Consequently, when we look at imbalances, we do need to look at them in the overall economic context because they might be telling us something not only about the near-term performance of an economy but also something very important about the underlying structure of that particular economy.

Q3 Chair: Anything you want to add, Mr O'Neill?

Jim O'Neill: Thank you very much for the invitation here, Mr Chairman. There are just a couple of things-broadly speaking, I would be in sympathy. Some imbalances in some countries appear to be a long-term phenomenon that reflects quite deep issues, including the demographic aspects of those countries relative to

the rest of the world. There is not a great deal you can do about them. In addition, there are some others, particularly small very open economies-Singapore and Switzerland being perhaps two of the best examples-that have had almost persistently large current accounts surpluses for a long time.

I say that as my first because I think one has to be careful about what one wants out of the issue of global imbalances. In a perfect world, every country having a current account balance at the same time as full employment would be Nirvana, but I cannot find much evidence of that ever really happening. One has to weigh up the pros and cons as to quite what one really wants from achieving a lower current account deficit or a different position on the-

Chair: It sounds good, although it might not always be so.

Q4 Jesse Norman: There has been some suggestion in the literature that global imbalances played an important part in the seizing up in the money markets over the last two to three years, and it is that I want to focus on at the moment. Mr O'Neill, could you just talk a little bit about conditions in the money markets at the present moment? Are you noticing credit default swap rates moving out, potential concerns in the interbank market?

Jim O'Neill: Can I just backtrack a little bit and say something else in addition to Gerard's answer to the previous question? I am in the camp that global imbalances, despite my cautionary comments a second ago, were at the core of the global credit crisis and in particular it was because a small number of countries, primarily the US and China, saw the degree of their imbalances get to a level of unsustainability that it was reasonably obvious that it had to change, and the credit crisis was the one that demonstrated it.

In that regard, I often find it surprising that in a number of countries-including this one in particular-many people do not seem to be aware of how quite dramatically some of the improvement in imbalances has been since, which is one of the reasons why I say, "Careful what you wish for". China's current account surplus this year will be at least half what it was before the global credit crisis-maybe a third.

So with that background, if I take exactly what you are asking me, it is arguably the case within Europe that at the core of the considerable problem we have in European Monetary Union or the euro area, there is a relationship between countries that have had large current account deficits and that are facing the biggest funding and financial crisis today-Spain and Greece, Greece in particular, being good examples. I am not sure exactly if that is the question.

Q5 Jesse Norman: If I could develop the thought a little bit more.

Jim O'Neill: Yes, please.

Jesse Norman: The thing I am worried about is the condition of the independent market and the money markets at the moment and, in fact, whether or not it is the case that we may be close to a renewal of a secondary banking crisis. Since we have you here, that is the question I really want to put to you.

Jim O'Neill: I don't think that is an issue directly to do with the current account imbalances. I think past imbalances are certainly a key, if not the main driver, to countries that are particularly under pressure. As I said, within Europe, Greece and Spain would be particularly good examples.

Q6 Jesse Norman: But just to be clear, you do not share my worry?

Jim O'Neill: No, I don't and in that regard-

Q7 Jesse Norman: So institutions are able to fund themselves relatively happily at the moment?

Jim O'Neill: I think there is a very important difference between the general ability to fund and the equity price. Because of the steps that were put in place in 2008 and early 2009 in many major economies, the ability to fund via their respective central banks, or in the case of the euro area the ECB, is now fairly deep and so even though it gets poor trade as having many similar characteristics in the past few weeks to 2008, I personally do not see, from a funding perspective, the parallels to be similar. There is an issue to do with the equity-

Q8 Jesse Norman: I understand. I think I am right in saying that Goldmans has called for a renewal of quantitative easing, has it not?

Jim O'Neill: In the UK?

Jesse Norman: Yes.

Jim O'Neill: Yes.

Q9 Jesse Norman: Could you just dilate on that because it seems to relate to some of these issues?

Jim O'Neill: I have to be very clear about how I answer that because these days I am the Chairman of our fund management business and I am independent of the Economics Department of which I was head for the past 15 years. So I have no direct influence over their decision to make that prediction, which they did last week.

However, knowing the general processes of what they go through, that will have been a judgement not based on funding issues but based on the most recent evidence of the UK economy and what the MPC's mandated goal is-what the MPC has been stating in its discussions and the most recent evidence of their previous meetings. So that would not be directly as a result of-

Q10 Jesse Norman: Just very quickly, Dr Lyons, tell us whether or not you share Mr O'Neill's sanguine view of interbank funding at the moment in the money market.

Dr Lyons: Just coming in very quickly on the first point Jim made, which is relevant for this in terms of linking it to the current account debate. Current account imbalances can be a very good lead indicator of problems to come; one saw that in the States, in the UK and certainly on the periphery of Europe. So the scale and the concentration of the imbalances is a big issue.

When one looks at the periphery of Europe, one could say that the imbalances that were there beforehand reflect uncompetitive economies or economies that need to adjust. When one looks at the money market situation in Europe, there are many issues coming in-it is confidence in the counterparty and confidence in how the crisis will unfold. In Europe we effectively have a political crisis that has led to an economic crisis that has led to a debt crisis that has led to a banking crisis. That is almost a self-feeding downward loop so what is reflected in the money markets, in my opinion, is the fact that there is a lot of uncertainty around and a lack of clarity as to how things would turn out.

But I agree very much with Mr O'Neill's point about the fact that policy makers have learnt from the last few years, have resources in place and are able to respond. That being said, that does not mean that everything will turn out rosy. Whichever economy one looks at-whether it is Britain, Europe, China or the States-the outcome depends on the interaction between the same three key factors: the fundamentals, policy and confidence. Specifically in terms of your question about Europe, the fundamentals are poor, the policy cupboard is almost bare and confidence is very fragile. Hence what the policymakers do in terms of restoring confidence in the financial markets, and then more particularly in terms of the wider economy, will be key in terms of how we go from here.

Jesse Norman: That is a very clear and helpful answer. Thank you.

Q11 John Mann: I have an interest in the way immediately some of the terminology comes into place. Taking those three countries, China, Japan and Germany, I put it to you that what there is there in essence-particularly in Germany and Japan-and easy to observe, is protectionism. There is a cultural protectionism backed up by the state, especially in Germany, but inherently within those economies there is a cultural protectionism in terms of how consumers, and producers, see the economy they are in.

We have gone, in this country, on the open doors, open markets model following the United States. I would be interested in your comments on that; of course, the third aspect, China, is somewhat different but there is communist party control and a state run economy, and therefore far more levers of protectionism from the state. How much of that is a factor in terms of why there are these imbalances? Is it important in your view,

secondly, to understand why they are or is the only real policy imperative for us to look at the consequences because they are?

Jim O'Neill: Thank you. You raise many issues with that question, but the first thing I would like to encourage you to think about in answering you is that the use of the word "protectionism" is not helpful in the current world we are in, post-2008. We have had many problems, some of which are re-occurring since the global credit crisis. One of the really fortunate aspects is that as of yet nobody is going down the route of trying to repeat things of earlier centuries or the last century, the 1930s, in terms of undertaking aggressive protectionist policies.

So in that regard I think one can sometimes get a distorted judgement about China in this role. Following on from that-and here I am sure Gerard and I agree because we know each other quite well-China is, in my opinion, quite easily the single biggest economic opportunity for any other country in the world in the decade we have started and possibly in the one ahead. They are increasing their imports at a considerable rate. Year-to-date annualised Chinese import growth is not far off $350 billion, which is about the size of the Greek economy. So China has essentially imported, or is importing, another Greece. German export growth, bringing in one of the other countries you mentioned, is being driven by China and so for countries that have got the right products, the right brand, China is probably the best thing that is likely to have happened to them in a long, long time. So to view China as-

Q12 Chair: Is this stock or the increase in growth, in imports? What was the figure you gave?

Jim O'Neill: That was the change. One of the reasons why I am very pleased to have been invited to this, because of its nature, is that I think there are a lot of misconceptions in this country about this issue, as there are in the United States. If Chinese import growth carries on at the same rates it has been the past two years, in the next five or six years the absolute levels of the stock of Chinese imports might be as big as the United States. So for people to think about it in such conventional terms, I think, is misleading.

I would reiterate in that regard that China's current account surplus has slowed significantly since the global credit crisis. In 2007, it was close to 11% of GDP; this year I said half, but it might not be any more than 4% of GDP, and it is because export growth has been slower but they have had very strong input growth. That is a major influence for many other economies and is offsetting some of the negative consequences of the US current account deficit coming down.

I could talk a lot about Germany and Japan, too, but I do not want to hog-

Chair: Do you want to come back on that, John?

Q13 John Mann: I am interested in this cultural question and how that might impact on policy makers, because there is a distinct difference of approach in those countries.

Dr Lyons: I would reinforce what Jim said, particularly on the China aspect about not underestimating the scale and pace of change in China. But coming back to your original question, I would not have used the term "protectionism" but I understand where you are coming from in terms of your question. What I would stress is the strategic emphasis that these countries have that I think we lack in the UK. There is a lot more strategic longer-term thinking. That does not mean that the Government picks winners and it does not mean that Government always wants to interfere in every aspect of the economy; it is about having the right infrastructure in place for the economy.

There is maybe a more nationalistic element in terms of consumer behaviour in some of these countries. That certainly is the case, but also there is an issue that some of them, particularly China, have to address in terms of the balance of its economy. One of the issues is that China, like many emerging economies-particularly in Asia-needs to shift from export-led to domestic-led growth. The Chinese 12th five-year plan, announced earlier this year, is probably the most important economic event this calendar year globally. That very much aims to move China towards domestically driven growth, which I think would address some of these issues. But that takes time and it requires some considerable changes that we could talk about later.

The area in which I think your original question has some relevance is on currency policy. I do think there is a question there in terms of what needs to be done in currency policy, but then if you see it again from the

perspective of the Chinese, they very much favour gradualism in terms of currency policy.

What are the lessons that I would take away from it, linking it into the current account debate at a global level? I think the case for global policy co-ordination that we saw existing at the time of the London summit was a big positive, but then it was in every country's domestic best interests to do what was needed then and that helped us all globally. One of the challenges in the current account argument is that not all countries see it as in their best interest to make changes as quickly as some others would want, which is one of the challenges. Coming back to the UK, I certainly think we can learn from countries like China in terms of longer term strategic thinking-particularly linked to, for instance, our infrastructure.

Jim O'Neill: Mr Chairman, can I just add one other thing that is directly relevant about the UK? In exploring a lot of data in preparation for this, I think it is important when you think about the UK that the UK's current account deficit has been pretty stable for the past decade and is quite unique among the G7 countries in that regard. We have a very large surplus on what is called the invisibles accounts. So we have a trade deficit of 5% to 6% of GDP, but a surplus in invisibles of between 3% and 4% of GDP, which means the UK in its services sector, across a whole range of areas, benefits considerably from things going on all over the world.

I say that because every country cannot be the same. People have their edge and historically Japan has appeared-less so today-but it has had an edge in certain manufacturing products. Germany seems to have had and still retains-particularly in the world where China and the other BRICs are becoming more important-a huge edge in manufacturing. For us to think that we can replicate that really quickly is probably quite naive, but in many international services we have a big edge that is helping the UK balance of payments.

Q14 Mark Garnier: You both started talking in depth about China and what I would quite like to do is concentrate exclusively on China for the duration of my questions, if I may. Starting on the currency, in America a lot of politicians are whinging about the fact that they have a trade deficit with China based on the fact that renminbi is pegged to the US dollar and is therefore extraordinarily cheap, all things considered. Is this a fair comment?

Jim O'Neill: No.

Mark Garnier: Do you want to expand on that?

Jim O'Neill: Well, the renminbi was formally pegged against the dollar to-what was it?-2006 and ever since that period, even though there have been different identifiable stages, the renminbi has risen by nearly-or maybe by now slightly more than-25% against the dollar. So this notion that it is pegged against the dollar is just not true.

Mark Garnier: It is abstract, yes.

Jim O'Neill: There is an argument to be had that it might not have appreciated enough, but I personally am not-if I had been sitting here four years ago I would have agreed with that view, but I think it is less clear these days.

Q15 Mark Garnier: Going forward then, if it is an adjustment of 25% over the last five or six years, where should it be, do you think, in terms of how it should have appreciated against the US dollar?

Jim O'Neill: I have spent a lot of my life on currency models as to what is the so-called equilibrium value and, as I am sure members of this Committee have experienced from reading about these things or have other people here talking about them, it is not exactly the most exact science in life. Then when you translate it to something like China, which is going through the scale and speed of change that they have, it is difficult to do-I have tried and I have people who have done it for me.

It is not so clear to me that the renminbi is significantly undervalued any more, and that is partly why I think the Chinese imbalances are moving. Most people who do these things would not agree with me, but I think this idea that the renminbi must rise by some dramatic amount that is going to result in some major change on imbalances is fraught with difficulty because it is very hard to know what that right level is, as we arguably saw with the whole issue about the yen 20 years ago. Maybe Japan let the yen rise too much for its

own good and there are much more important issues involved, such as the level of domestic savings in China, the level of savings in the US and so on.

Q16 Mark Garnier: I want to come to all that, in fact. I think Yiping Huang from Peking University has argued that, "Relying exclusively on currency adjustment to correct the overall external imbalance requires an outsized appreciation which is difficult for China to accommodate, both politically and economically." You also alluded a bit earlier to the fact that the import growth is going up about $350 billion this year so they have effectively imported an extra Greece this year and exports are dropping in terms of GDP.

Do you think that we are seeing quite a rapid cultural shift in terms of consumer demand within China? You talk about this consumer demand, but there is this vast, vast hinterland of peasants who are developing. Is this happening quite quickly and are we underestimating that?

Jim O'Neill: I think there has been a sort of bipolar development of the Chinese consumer. At the higher end, it has been explosive. If you look at the data available both in terms of national data of countries that export to China or where China imports from-or, just as interestingly, the performance of the world's best branded consumer goods, including some British ones-their fortunes are being transformed by the emergence of the wealthy Chinese consumer.

Q17 Mark Garnier: When you talk about "best branded", you are talking about Dunhill lighters, Mont Blanc fountain pens, Cartier handbags-that kind of stuff-aren't you?

Jim O'Neill: Louis Vuitton, luxury cars and so on. But then at the lower end the number of people who have been taken out of poverty in China in the past decade goes into the hundreds of millions, which is why at a completely different class of consumption there are huge changes. Another British firm, Tesco, is the largest expanding overseas retailer in China because of that segment of the consumer market. So a lot of these changes have been going on for a while and, as Gerard said earlier, the latest five-year plan is geared towards growing the role of the 1.3 billion Chinese people who are there as a bigger share of consumers, as arguably policy priority number one.

Q18 Mark Garnier: But there is a cultural savings thing within China. People comfortably save and it has been argued that that is because there is no security, if you like, from the state in old age. Dr Lyons, is part of that five-year plan-and I have not looked at it in detail-dealing with that in order to try and essentially free up savings for consumers?

Dr Lyons: I wonder if I can answer that by putting it also in an Asian context. At the annual Asian Development Bank meeting in the immediate wake of the financial crisis-so it would be the one two years ago that was held in Indonesia-it was identified that for Asia to move from export-led to domestically-driven growth, three things needed to be in place: one, social safety nets to discourage precautionary savings; second was help to the SME, the small to medium-sized enterprise, sector, to create jobs; and third and very importantly, deeper and broader bond markets.

I would take it further and say deeper and broader capital markets, and that is a big potential positive for us here in the UK, given the strength of the City. But when you look at China, the 12th five-year plan is trying to put that in place in terms of China now. The 12th five-year plan had, I think, 62 chapters, but there were three key overall themes: one, social safety nets; second, boosting domestic consumption; and third, the green economy. So China does need to move from export-led to domestically-driven growth, but when one looks at China it is not just high personal savings, it is high corporate savings as well. Jim touched on demographics very early on, but China's population starts to age quite significantly, I think, from as early as 2014. In contrast, half of India's population is under 25-China has both a gender issue and an ageing issue. That does not undermine the pace and scale of change in China, but it will eventually slow the future pace of growth.

But one should be positive. Maybe the one thing I would stress at the moment is that if one looked at Britain, Spain and America, we had that lethal combination of cheap money, leverage and one-way expectations. One of the questions I am most asked about China is, is China a bubble economy? The answer is categorically no. China is undergoing an industrial revolution and I still think people underestimate what is not only happening in China but the impact of that across the emerging world. But while China is not a bubble economy, my view is that it is an economy prone to bubbles in its property sector. That is where it has the

lethal combination of cheap money, leverage and one-way expectations. Possibly the biggest challenge for China is that as the economy opens up and becomes bigger, it becomes harder to run from the centre. So we should expect setbacks in China; that is a part of the business cycle, but the trend is undoubtedly up.

Just to conclude, to put it in global perspective, the Chinese economy is now $6 trillion in size. When you talk globally, the world economy, despite the financial crisis and despite the dotcom boom and bust, has moved from a $32 trillion economy 10 years ago to a $64 trillion economy now. So despite the problems in the West, the world economy has doubled in size in nominal terms. So while we overcome the crisis, at the same time we need to be recognising the opportunity that Jim touched on in terms of the domestic market, not just in China but globally. We need to recognise that while there are big near-term challenges, there are phenomenal longer-term global opportunities for the UK.

Q19 Mark Garnier: Have you got any timescale on this, if you like, accelerated industrial revolution? How long is it going to keep on going for?

Dr Lyons: We did a detailed analysis at the end of last year and we found-in answer to your question, we did a forecast up to 2030, not because we think that is going to be the end of the growth period, but we wanted it sufficiently far ahead to be a proper forecast but not so far ahead it did not matter. But we saw China growing on average at 6.9% per annum over that 20-year period, and India growing at 9.4%. We felt that the world economy in real terms would grow from $64 trillion, or $62 trillion when we did the analysis, to somewhere between $129 to $143 trillion.

Now, the forecast might not be exact but the point is that, despite the near-term challenges, we should not lose sight of the opportunity to-maybe very briefly we felt that there were two previous periods globally that were similar to what is going on in the emerging world now. One was 1870 to 1913, when we saw the growth of America as a super-economy and the adoption of technologies from the industrial revolution; then, the world grew by 2.7% per annum on average, although very volatile. The second phase that was very similar in some respects was 1945 to the early 1970s: we saw the emergence of Japan and a few Asian tigers plus the growth of consumer durable markets, and naturally the post Second World War reconstruction. World growth then was 5% per annum over that period. We think that over the period 2000 to 2030, global growth will average somewhere between 3.5% on our base scenario to even higher on our upbeat scenarios. So in answer to your question, I think it is right to take a 20-year scenario, but do expect setbacks along the way over this period.

Q20 Mark Garnier: It is quite a big growth rate, isn't it? Do you think that is really sustainable or is China that significant an engine for growth?

Dr Lyons: It is not just China; what you are seeing is two big developments. You are seeing the growth of middle class consumer markets, not just in China but in other countries around the world, and you are seeing the growth of what we call new trade corridors-south-south trade might be the term that other people are familiar with.

The important thing, coming back to your question on the figures, is that it is not always the right thing to get het up about, whether it 3.5, 3.9 or even lower, but to recognise the shifts underway. There is a big problem with debt deleveraging in the West that we need to address, and we cannot hide from that. But at the same time we need to recognise-going back to your question on Germany and Japan-the strategic emphasis some other countries have. When you look at what is happening in the emerging economies, they are not decoupled from what happens in the West. They cannot avoid having setbacks if the West has a big setback but there are some big underlying shifts that will continue for some time, whatever the rate of growth.

Q21 Mark Garnier: One thing that John Mann was talking about was this sort of protectionism. There is quite an interesting cultural thing with China over the last 20 or 30 years as when you look at countries around the world, they have cultural reform, they have economic reform and they have political reform. The one thing that has always struck as being very clear about what is happening in China is that in order to maintain political stability they have encouraged economic and cultural reform and have been very good at this.

But at the end of the day, you have an extraordinarily strong, dictatorial-and I do not mean it in an unpleasant way-and controlling Government. Given this colossal opportunity that you talk about in China, do you not

think that at some point in the future they may recognise this as something which they can use to develop their own economy even faster-to the cost of the Western world? That, I think, was what John was getting at.

Jim O'Neill: To the cost of the Western world?

Mark Garnier: Well, to the exclusion of the Western world, perhaps. So, not necessarily allowing Tesco to expand quite as quickly as it wanted to in China, but preferring a local Chinese-based but Western-brand-type of alternative.

Jim O'Neill: I do not know whether you or the Committee are aware of this, but I have the dubious pleasure of being the creator of the BRIC acronym, so I am full of about 15,000 times the statistics you have already heard. Before the end of this decade the aggregate dollar value of the consumer in the four BRIC countries is likely to be bigger than the US. It is the biggest economic opportunity of our generation. China is half of it, the other three are about the same collectively. The best internationally minded countries or their leaders and the best internationally minded companies will thrive by being immersed in the middle of that. I am a strong believer that that is the most dominant thing going on in the world economy, which is why the kind of growth rates that Gerard said are justifiable.

If I got to the last part of this question, is there a chance that at some stage China just suddenly says, "Well, we don't want any of you guys to benefit from it"? Of course there is. But I think as their individuals get wealthier and their aspirations grow, linked to the success they have had that you mentioned, adapting in their leadership style to the changing and rising aspirations of their people will remain key. If foreign entities can keep an edge and a brand that the 1.3 billion Chinese or the 1.2 billion Indians want, that is going to be pretty difficult for their Governments to stop.

Q22 Michael Fallon: Can we turn to stresses within the eurozone itself? Can you give us any advice on the imbalances within the eurozone? Do they matter? Are there any signs of Germany moving towards a more consumer driven economy?

Jim O'Neill: Michael, is that for me or both of us?

Michael Fallon: Whichever.

Dr Lyons: You can go first.

Jim O'Neill: Thank you. It is a complex one because in the aggregate the euro area does not have current account surplus, as you know. So from a simplistic truly global consequence, the euro area's weaknesses in this area are offset by its strengths. So in a simplistic sense, Germany's surplus offsets other countries' weaknesses. Going back to something I said at the start, you have to be careful what you wish for. Life is not just about, or should not be, whether a current account is in balance or not; it is how they are in the state they are, what is behind them and how they shift.

So going to what I think is the meat of your question, I am generally somebody who sees the world economic glass more half full than empty, but the one thing that really bothers me at the moment is the euro area and policy in it because Germany is very good at exporting-you touched on it before-but it has not been the world's greatest consumer. It appears that their recommended recipe for solving the challenges of the other countries is for them to do more of what Germany has been good at-i.e. to not consume so much, especially on borrowed money, and to improve their current account balance through that vehicle and somehow try and be better exporters. That is a recipe for, let's call it, lesser imbalances within the euro area but one with weak, and virtually zero-if even that-domestic demand, which would be, from a global perspective, troubling. Certainly from a UK perspective because, of course, it remains our absolute biggest trading partner.

Dr Lyons: Coming to your question on the stress. Throughout this calendar year, I have regarded the global economy as being a divided and disconnected world with big policy dilemmas. The divisions are east versus west, core versus periphery in Europe, in fact big firms versus small firms in the States and in the UK. The disconnect is very much high unemployment-particularly high rates of youth unemployment. This is leading to lots of policy dilemmas. In some respects, which is the reason for mentioning it in this context, all these issues come to a head in terms of Europe. I think that just as we on the outside of the euro area should not underestimate the political commitment in the euro area to keep the whole thing together, politicians and

policy makers at the centre of the euro or the core should not underestimate the economic pain that the periphery is having to take in order to stay within the system.

When one looks at economic and monetary union, I tend to say that the MU part, the monetary union part, works-albeit with caveats-but the economic aspect clearly does not work. What we have is that countries on the periphery are in a system where they do not have the same economic characteristics as those at the core. So the idea of Germany spending more I do not think really solves the problem.

I think what we had in terms of the imbalances that were clear beforehand in terms of the periphery is reflected in very uncompetitive economies, and if they are to remain in the current system then they do need more help from the centre. For this system to survive in its format it needs, in my view, to become a political union with one central Treasury. The policy makers could have addressed the issue, in my opinion, earlier but by allowing contagion from Greece, Portugal and Ireland to Spain and to Italy, it now moves things into a very different scale, which is why the markets are very worried and why indeed people across the emerging world are concerned about how things will play out.

Q23 Michael Fallon: The help that they seem to have had, the lending flows over the last four or five years, of course have fuelled asset price bubbles in these Mediterranean countries; they have not really triggered the kind of reforms in labour markets and so on that one would have expected to see. How do you make the help more sensible?

Dr Lyons: In some respects, even though we are not in the euro area, you could argue that the same issues apply to us here in the UK, even though of course we have had the benefit of setting domestic monetary policy and currency policy to suit our own domestic needs. It is the whole issue about-macroeconomic policy is one aspect, but it is the whole structural issue in terms of the economy that needs to be addressed.

In terms specifically of the peripheral economies in Europe, I don't think they can cope so therefore the shock absorber for them is going to be continued high rates of unemployment. Ireland socially seems-if you read the papers, and I am not an expert on Ireland-to be able to cope better but they, at the same time, do have a large amount of net migration. The high rates of unemployment are the big shock absorber and I think therefore-I personally don't think these economies can continue without further help from the centre, but the part of the conditionality for help from the centre is further tough measures. But you are right-the time to change anything is in the good times, but the reality is that you are asked to change in the bad times, and that is when an economy is least able to cope.

Q24 Michael Fallon: Do you want to add to that on the kind of help the centre should be offering?

Jim O'Neill: As you implied with the question, or maybe I read too much in it, in hindsight probably too many countries were allowed to join the European Monetary Union. I say that because the need to adjust to the rules has clearly been flouted by many if not, at times, everyone in it. But for some, particularly many of the Club Med countries, it seems to have been particularly difficult. This is part of the current policy dilemma. Many German observers and policy makers probably think just giving them more support will encourage them to carry on the same path they were on. So we have answered a really quite fragile and tricky situation.

Perhaps in slight contrast to how Gerard answered the last part of that, I have learnt, I think, through my career that crises frequently happen and it is tough to stop them if the underlying fundamentals were never there in the first place. How you respond to a crisis and improve things in it or from it is often key, and it would seem to me, broadly speaking for the euro area, that introducing more common fiscal authority across countries and/or-probably and-one that has some power, is absolutely vital to finding a solution here because it brings the economics and the politics together. The Germans, understandably-and, by the way, other smaller but suitably similarly fiscally responsible countries-do not want to keep on giving more money and probably shouldn't if it is not going to result in any underlying economic and lasting policy changes.

Q25 Tom Blenkinsop: I am quite interested in what Gerard had to say in relation to the surplus nations, which are primarily manufacturing countries like Germany and Japan. In Japan you have a low social security system but still low consumer spending whereas in Germany you have a higher value social security system but still low consumer spending. Is that a cultural phenomenon or do you think there is a state element of planning, if you like, in relation to creating a cultural phenomenon in those countries?

Also, and I don't not think it is necessarily what John said in relation to protectionism, but the economic planning and structured systems that we have in the surplus nations that are predominantly manufacturing and export nations, bring down that industrial cost stream. The surplus economy countries or the primary manufacturing exporters like Japan and Germany-do you think those economies have changed identity over the last 50 or 60 decades? Which countries do you think have changed their identity and why?

Dr Lyons: Sorry, in terms of the first part of your question, if I have understood it correctly it is about the cultural difference between Germany and Japan in some respects or between those economies and the emerging economies in Asia. The challenge of course is-well, I think culture does play a part. Again, it is like the first question the Chairman asked about global imbalances in terms of the crisis; with any of these things it is very difficult to quantify fully, but I think it is very difficult to compare emerging economies at their current stage of development now with economies such as Germany, which introduced the pension system under Bismarck at the tail end of the 19th century.

But a social safety net is seen in economic terms to be an important factor in terms of discouraging excessively high rates of savings. I think the make-up of the German economy is very different-again, like Jim, I was looking at data before coming here; it was interesting to look back at how much the UK has lost out in terms of export markets-and indeed we lost out in our share in export markets to the emerging world until a few years ago, when it started to rebound. But in some respects the manufacturing sector here, while it is first class and excellent in certain areas, the scale of it is much less than Germany. So many aspects come into play-social policy, culture in terms of individuals maybe, but also the anti-inflation mentality as well; house prices and debt are seen as a big difference here compared to how they are viewed in Germany. Certainly, one would view the German economy very differently to Japan and to China.

In a nutshell, I am saying there are so many different factors that it is very challenging in a short answer to come back, but I do think culture plays a role in some respects. Maybe the question is what we can learn from that here in the UK? Is that what you are getting on to as well?

Q26 Tom Blenkinsop: I think part of it is what you mentioned: that China needs to have one pillar of the change through increased consumption-

Dr Lyons: Yes, in terms of a social safety net.

Tom Blenkinsop: -to increase social security.

Dr Lyons: Yes, maybe to put it into context, Hu Jintao and Wen Jiabao, five, six years ago talked about China's five imbalances. They were not all economic imbalances but the five that the Premier and the Prime Minister then highlighted were, in no particular order, let's say, one was coastal inland, that was a big imbalance; second was urban rural; third was social; fourth was environmental; and fifth was international. So given these imbalances and on top of that the fact that investments in relation to consumption and exports is such a high proportion of the economy, they have macroeconomic imbalances on top of these other imbalances. So, given all that, it is remarkable how well the Chinese economy has done.

So in trying to address these imbalances, the Chinese are effectively trying, in my view, to move from strong growth at all costs to more sustainable rates of growth, which is why a social safety net is a very important factor. But I would suggest in conversations with various people from China that they do not want to necessarily follow the European model of social safety nets that you have alluded to because that is a very costly model. What they need is a model that suits their domestic circumstances.

Jim O'Neill: I don't see an obvious common link between manufacturing strength and the chosen social provision, if that is really what you are getting at. You yourself said there are quite a few differences in the countries you cited. It is very complex and, on a really simplified angle, one could argue that the historical strength post-war of Japanese and German exports is sort of based around the auto industries. I am sure in the early days that there were major elements of Government support for that. But particularly in two countries which have had huge-bringing in some aspects of the currency issue that was raised briefly earlier, in the days before the euro; and despite all its problems, the euro is still very strong-Japan and Germany have both had to cope with huge currency strength over repeated periods. The Governments have not protected them in that sense.

One of the most remarkable things I often observe, if you look today at many value-added input parts of the world auto industry-and I speak to many auto executives-you often think that currency is an important point, but despite all that and despite the strength of the mark and the strength of the euro, here is Germany doing exceptionally well at exporting cars made in Germany to China. So I think there is grave danger in pushing too far some of these, again, superficial things that appear to be said about a protection policy to support the industry. I think in the case of the ones I follow-I would say the German ones-this is what they are really good at. They have a brand and they have high productivity, and it is something that people desire.

Dr Lyons: Just very briefly, I would certainly reinforce Jim's point about currencies not being the only issue here. The underlying structure of the economy is vitally important. I think it is a complicated issue because certainly when one looks at the Western world, the relative price shock that we experienced here early this year could easily be repeated in future years. So certainly UK manufacturing, like US manufacturing, is going to benefit or is likely to benefit from a weaker pound and a weaker dollar, but-as Germany and Japan have shown and as Jim has touched on, and indeed as China is now trying to do by moving up the value curve-it is more than the currency issues, it is the underlying structure of the economy, certainly.

Q27 John Thurso: Can I ask you to put current global imbalances into a historical perspective? How much is this a completely new phenomenon or has it happened before in history?

Jim O'Neill: In my opinion, it is not particularly new. The scale of the imbalances that we had just ahead of the peak of the global credit crisis was on a degree that was quite unaware-no examples of historical. The US current account deficit was above 6% of GDP and the counterpart to it was the US domestic savings rate; household savings rate was close to zero. A month before Lehman Brothers went bust, the US personal household savings rate was less than 1%. That was fairly unprecedented historically and what has happened since, and there is a great debate as to how much of it is cyclical and how much is structured. The imbalances we currently have have been seen in the past.

Dr Lyons: Maybe if I could just make a few points. I agree with those points. Maybe one of the differences this time was the scale and the concentration, as Jim has touched on-the scale of the deficit in the States and the concentration of where those imbalances were.

Another aspect this time around was the fact that "water was flowing uphill"-that was the phrase used to point out that normally emerging economies at an earlier stage of development ran deficits. They offered the better investment opportunities and they attract the investment inflows. Another big difference in relation to this crisis compared to before was that savings were flowing from the emerging world to the West and, indeed, the US deficit was very much mirrored by the surplus across Asia and the Middle East. This has led some people to say there was a savings glut and the emerging economies were to blame for the crisis; Mervyn King and Charlie Bean here in the UK have talked on this.

The Bank for International Settlements has recently talked about a big difference between net and gross flows-i.e. a big difference between savings and financing. Their point is that it would be wrong to conclude that emerging economies were to blame for the crisis because there were net flows of savings from the emerging world to the West. We saw big gross flows between Europe and the States-in fact the UK, a debtor country, was financing some of the US current account even though that was a debtor country.

So what we saw this time around was that the scale and concentration were greater. This time around we also saw flows from the emerging world to the West. But also this time, because of the development of the financial system compared to previous cycles, we saw a further complication in terms of gross flows as opposed to net savings flows. So we have seen imbalances before but there were extra caveats I would suggest this time.

Q28 John Thurso: I remember when the predecessor to this Committee was visiting Washington in 2007-this was pre-crash, just, and pre-Northern Rock, just. We were doing an inquiry into globalisation at the time. There was already considerable discussion about global imbalances. The Governor of the Bank of England has raised it on numerous occasions as a core feature. I remember in the mid-1990s the Asian capital problem and Singapore being in grave difficulty, and I think they were in quite considerable deficit around the Asian countries. What I am trying to get a handle on is whether this is something about sound management, "steady as she goes and we will get out of this", or it is a phenomenon that we have not seen

before that needs radical thinking and a radical approach? I have not yet heard evidence anywhere to let me know how I am supposed to be thinking.

Jim O'Neill: Can I expand on my brief answer to you earlier? If I had been sitting here in 2007, I would have said it was extremely worrying because, as I said, the scale of the imbalances then was very large by any stretch of history, particularly for large economies like the US and China. A lot has changed in four years. The US current account deficit is half what it was, the US current account surplus is half or less what it was, which brings it into the realms of imbalances that have come and gone on a global scale over certainly the previous 30 years of floating exchange rates, and in periods before.

I would also like to reiterate what I said earlier: the UK has not been without its considerable historical balance of payments challenges, Mr Chairman, as many people in this building have found out. By those standards, the UK balance of payments is not that problematical. Again, I would reiterate that we have a large trade deficit that is reflected in some of the challenges we have as a relative expert in manufacturing, but because of the strength of the invisible surplus, our current account deficit, although it is deficit, has been reasonably stable.

Dr Lyons: Can I just come back? I think this is a very big issue, both at a national and at a global level. At a national level I think it is a big issue because current account deficits, particularly if they become very sizeable and very sustained, tend to be an early warning sign of problems to come. That does not mean that you can't have a current account deficit and still be in good shape if you are borrowing for investment. It also does not rule out having a current account surplus as Japan did before its bubble burst, and having a bubble at home. But I think if you have a big sustained current account deficit, it is reflecting-it should be sending warning signs or setting off alarm bells because it is telling you something not just about the cycle in your economy; it could be telling you something about the structure of your economy. So at national level these are very important. Quite frankly, in the UK we failed to heed the warning signs of this many times.

At a global level, I think it is very important because when we tend to try and adjust from big imbalances the argument has always been that it is for the debtors, the deficit countries, to get themselves into shape; the pressure has never been really on the surplus or savings of countries to get themselves into shape.

In some respects, it is like the debate that Jim was touching on about the euro area, when one looks at Germany. Germany might argue why should it change its overall behaviour? "Why should the good become like the bad?" is how somebody in Germany explained it to me. The challenge, of course, is when you have big imbalances, if they are to be addressed by debtors spending less, savers spending more and currencies adjusting, if the savers do not want to spend more then what you build in is a demand deflation into the global system. That is why at global level it is important that your balance is addressed, but as I stress at the national level it tells you lots of potential things.

Jim O'Neill: If I can just interject, one of the things that Gerard just raised is a really powerful illustration of what I am trying to say. If the euro area were the world and your only focus in life was having balanced current accounts, you would see the euro area as having no problems because it is close to balance. So trying to have a balanced global current account is wonderful in principle but how long to achieve it and the cost of trying achieve it are at least as important, if not more. In 2007, the size of the US deficit and the clear evidence of absence of domestic savings, and the flipside of that in China, were hugely powerful warning signs of trouble ahead. Because of the crisis they have both-possibly temporarily; who knows?-improved a lot.

Q29 John Thurso: In a way, you are saying that getting the imbalances right is not that big a problem sort of thing. I know that is a very brief encapsulation of quite a complex environment, which will confuse a lot of people because deficit is a bad word. It brings to mind the question of what, if any, relationship is there between current account deficit and budget deficits.

Dr Lyons: I remember when I first started in the City writing a column in the *Times* newspaper in the mid to late 1980s on why the current account deficit mattered more than the budget surplus or deficit and why the Lawson boom was going to become a bust at that time. I remember being heavily criticised by many people because they were arguing that the budget issue was more important.

The current account is a reflection of where the public sector plus the private sector is going. So the current account deficit equals public plus private and within the private is households plus corporates. So effectively the current account equals public plus household plus corporates. When one looks at it, one needs to be putting it in the overall context of not only the scale of each of those components, but where we are in terms of the economic cycle and maybe the policies that you can then use if you want to bring things back into balance. So in answer to your question, I think you need to look at it in terms of the numbers themselves and where you are in terms of the cycle. You shouldn't necessarily take the view, as some people did during that Lawson boom, that what was happening on the budget was more important that what was happening on the current account. I think it needs some pragmatism as well.

Q30 Chair: Thank you very much for coming to see us today; it has been extremely valuable. This will be the first of quite a long inquiry, I expect-a long burn. Very, very interesting points have been made that we will need to digest. Thanks for coming.

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