Global imbalances threaten the survival of liberal trade

Martin Wolf, *Financial Times*, December 2 2008

The world has run out of willing and creditworthy private borrowers. The spectacular collapse of the western financial system is a symptom of this big fact. In the short run, governments will replace private sectors as borrowers. But that cannot last for ever. In the long run, the global economy will have to rebalance. If the surplus countries do not expand domestic demand relative to potential output, the open world economy may even break down. As in the 1930s, this is now a real danger.

To understand this, one must understand how the world economy has worked over the past decade. A central role has been played by the emergence of gigantic savings surpluses around the world. In 2008, according to forecasts from the International Monetary Fund, the aggregate excess of savings over investment in surplus countries will be just over $2,000bn (see chart).

The oil exporters are expected to generate $813bn. Remarkably, a number of oil-importing countries are also expected to generate huge surpluses. Foremost among them are China ($399bn), Germany ($279bn) and Japan ($194bn). As a share of gross domestic product, China's current account surplus is forecast at an astonishing 9.5 per cent, Germany's at 7.3 per cent and Japan's at 4 per cent. In aggregate, the oil exporters, plus these three countries, are forecast to generate 83 per cent of all surpluses.

Surplus countries often enjoy contrasting their prudent selves with the profligacy of others. But it is impossible for some countries to spend less than their incomes if others do not spend more. Lenders need borrowers. Without the latter, the former will go out of business.

In 2008 the big deficit countries are, in order, the US, Spain, the UK, France, Italy and Australia. The US is far and away the biggest borrower of them all. These six countries are expected to run almost 70 per cent of the world's deficits. (It should also be noted that the world seems to be running a $350bn surplus with itself.)

One might argue that Spain, France and Italy merely offset Germany's surpluses within the eurozone. It is true that the eurozone as a whole is forecast to run a small deficit of $66bn. This does not mean that Germany's vast surpluses have no global macroeconomic impact. Despite being the world's second largest economic area, the eurozone makes next to no contribution to offsetting surpluses elsewhere. Furthermore, pressures on the eurozone's deficit countries are growing. Fiscal crises are at least conceivable in some cases.

As I have pointed out previously, the most interesting feature of the global imbalances has been the corresponding pattern of domestic financial imbalances. The sum of net foreign lending (gross savings, less domestic investment) and the government and private sector financial balances (the latter the sum of corporate and household balances) must be zero. In the case of the US, the counterparts of the net foreign lending this decade were, first, mainly fiscal deficits, then government and household deficits equally and, finally, government deficits, again (see chart). During recessions, the private sector retrenches and the government deficit widens. Similar patterns can be seen in other high-income countries, notably the UK.

Housing booms helped make huge household deficits possible in the US, the UK, Spain, Australia and other countries.

So where are we now? With businesses uninterested in spending more on investment than their retained earnings, and households cutting back, despite easy monetary policy, fiscal deficits are exploding. Even so, deficits have not been large enough to sustain growth in line with potential. So deliberate fiscal boosts are also being undertaken: a small one has just been announced in the UK; a huge one is coming from the incoming Obama administration.

This then is the endgame for the global imbalances. On the one hand are the surplus countries. On the other are these huge fiscal deficits. So deficits aimed at sustaining demand will be piled on top of the fiscal costs of rescuing banking systems bankrupted in the rush to finance excess spending by uncreditworthy households via securitised lending against overpriced houses.

This is not a durable solution to the challenge of sustaining global demand. Sooner or later – sooner in the case of the UK, later in the case of the US – willingness to absorb government paper and the liabilities of central banks will reach a limit. At that point crisis will come. To avoid that dire outcome the private sector of these economies must be able and willing to borrow; or the economy must be rebalanced, with stronger external balances as the counterpart of smaller domestic deficits. Given the overhang of private debt, the first outcome looks not so much unlikely as lethal. So it must be the latter.

In normal times, current account surpluses of countries that are either structurally mercantilist – that is, have a chronic excess of output over spending, like Germany and Japan – or follow mercantilist policies – that is, keep exchange rates down through huge foreign currency intervention, like China – are even useful. In a crisis of deficient demand, however, they are dangerously contractionary.

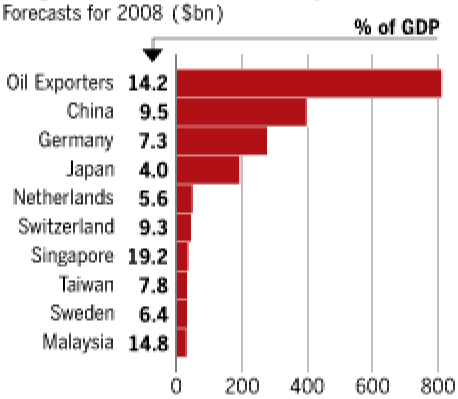
Countries with large external surpluses import demand from the rest of the world. In a deep recession, this is a "beggar-my-neighbour" policy. It makes impossible the necessary combination of global rebalancing with sustained aggregate demand. John Maynard Keynes argued just this when negotiating the post-second world war order.

In short, if the world economy is to get through this crisis in reasonable shape, creditworthy surplus countries must expand domestic demand relative to potential output. How they achieve this outcome is up to them. But only in this way can the deficit countries realistically hope to avoid spending themselves into bankruptcy.

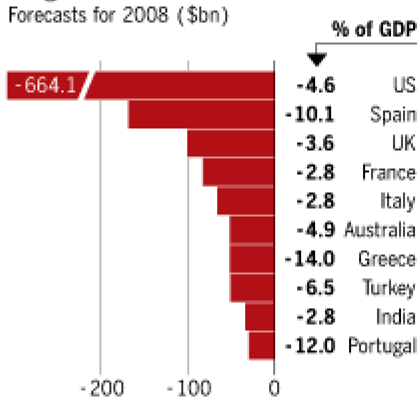
Some argue that an attempt by countries with external deficits to promote export-led growth, via exchange-rate depreciation, is a beggar-my-neighbour policy. This is the reverse of the truth. It is a policy aimed at returning to balance. The beggar-my-neighbour policy is for countries with huge external surpluses to allow a collapse in domestic demand. They are then exporting unemployment. If the countries with massive surpluses allow this to occur they cannot be surprised if deficit countries even resort to protectionist measures.

We are all in the world economy together. Surplus countries must willingly accommodate necessary adjustments by deficit countries. If they decide to sit on the sidelines, while insisting that deficit countries deserve what is happening to them, they must prepare for dire results.

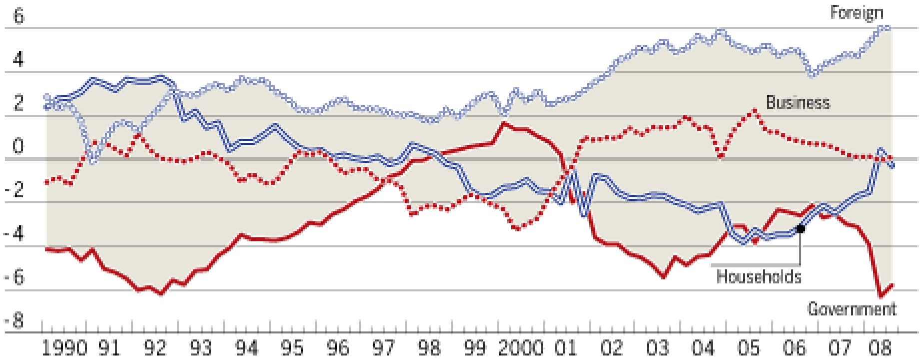
Largest current account surpluses
Forecasts for 2008 ($bn)



Largest current account deficits
Forecasts for 2008 ($bn)



US sectoral financial balances
As a % of GDP



Sources: IMF; BEA