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Recycling Global Imbalances

Is the United States at long last getting serious about global imbalances, or are we risking currency wars that can end in unmitigated disaster for all?

Is the United States, at long last, getting serious about global imbalances, or are we risking currency wars that can end in unmitigated disaster for all? Certainly tension with China is on the rise. Any advantage from a lower currency for any country is a zero-sum gain for the world economy as a whole. At best, it is about how to distribute the pie, not about growing it.

Until recently, many economists were not sure if global imbalances were something to be worried about at all. If markets always worked efficiently, as most economists accepted as an article of faith before the crisis, there had to be a rational explanation as to why these imbalances were, if not a blessing in disguise, at least, an innocuous outcome. Capital was flowing into the United States from the rest of the world for a reason. Maybe it was the benefits of the deep, highly liquid, and efficient U.S. financial markets, or perhaps they were simply trying to invest in the United States' superior productivity growth.

Some even argued that the imbalances were simply an illusion created by poor accounting, a result of the failure to capture the true value of the financial services the United States was "exporting" to the rest of the world. This was the optimistic view that believed in the wisdom of the market.

Then, there were the pessimists who feared that foreign demand for U.S. financial assets would sooner or later fall short of what was needed to finance the rapidly growing current account deficit. They differed on how imminent the danger was and on what shape a hard landing would take, but invariably, feared a run on the dollar and prohibitively high interest rates. They all agreed that sooner or later, the United States would need to save more, and that it would help if China stopped manipulating its currency.

Unsurprisingly, the more optimistic arguments began to wear thin as early as the bursting of the dotcom bubble, only to die out slowly with the financial crisis. The argument that the U.S. stock market boom in the late 1990s reflected booming productivity growth, and thus rational expectations about a much higher level of future income in the United States, was hard to maintain after the dotcom debacle, but managed to survive until the financial crisis. Likewise, the argument that the surge in house prices reflected improvements in quality quietly petered out only after the real estate bubble burst.

But the financial crisis has raised questions for the pessimists as well. Most notably, the crisis was not triggered by a run on the dollar caused by a disorderly unraveling of global imbalances, as many had feared, but instead by problems of the market provision of liquidity within the financial system itself. For instance, it was hard to discern a direct connection between the purchase of toxic U.S. mortgage-backed assets by foreign banks, which transmitted the crisis to Europe in its decisive initial phase, and the financing of the U.S. current account deficit. It hardly seemed to be the case that the crisis would have been prevented had the major players undertaken a timely coordinated policy intervention to reduce global imbalances.

Despite these questions, the pessimists' basic understanding of global imbalances appears to have survived the crisis to become the new conventional view.

The following are its basic tenets:

- imbalances are the ultimate cause of the crisis;
- they are the result of overspending, mainly in the United States and exacerbated by the undervalued currencies of East Asian surplus countries;
- one way or another, spending has to fall in deficit countries and rise in surplus countries; and,
- taking steps to enhance exchange rate flexibility would help to achieve that end.

None of this is new, of course, but emphasis on the importance of financial regulation is one addition. Previously, overspending used to be blamed on government budget deficits, but after the crisis, another culprit emerged: the failure of financial regulation to detect and prevent excessive credit growth which made it possible for households to over-consume.

Imbalances versus Recovery

Now that the finance bill has passed, the Obama administration and the U.S. Congress seem to be turning their attention to the surplus countries' role in global imbalances. In their view, if only China would let the renminbi appreciate, China would save less and the United States would save more, causing global imbalances to shrink. Of course, the pain that would imply is often ignored. Cutting down global imbalances now would require cutting demand in the United States in the midst of an anemic recovery, which could be disastrous.

Economists often talk from both sides of their mouths to deal with the problem: Raising spending is advisable in the short run to revive growth when in a slump but needs to be curtailed in the long run when growth is restored.

The trouble is that the short-run fix takes us further away from the long-run target, without any clear idea how we are to go from the former to the latter. For instance, at the nadir of the crisis, there was a significant reduction in global imbalances with a sharp contraction in world trade. And, with the revival of trade since the recovery, global imbalances have begun to widen again. Does it then follow that the world is farther away from a solution to its structural ills today than when it was at the bottom of the slump? Arguably, the conventional view offers little policy guidance for here and now.

It is possible that the conventional view also fails at a deeper level, for it assumes a world that no longer exists. It implicitly presupposes an *inter*national economy consisting of distinct national economies with their own separate systems of financial intermediation tied to one another mainly through trade. In other words, it assumes a world where financial assets are traded to move goods; where central banks control credit growth and where the current account rules the roost.

Of course, none of this is consistent with the increasingly *trans*national world we inhabit. The expansion of cross-border financial transactions began to outstrip the expansion of goods trade as early as the 1970s, but their increase with the rapid acceleration of financial globalization since the 1990s has simply been spectacular. In this new world, it is misleading to assume that the asset trade is still auxiliary to the goods trade.

All of this suggests another way of looking at global imbalances which provides a very different understanding of the nature of the problem we face. Think of Bernanke's "savings-glut" thesis—and, ignore its frequent Pollyanna-ish use. It basically says that the U.S. credit boom–that led to overconsumption, and thus the ballooning trade deficits –was in turn caused by money flowing into the US from the rest of the world through its capital account. In other words, it was ultimately the capital inflows that fueled the credit expansion and brought long-term interest rates down, making it possible for U.S. households to overspend and thereby be the engine of world growth.

In this view, what needs to be done to restore world growth is not as obvious as in the conventional view. Here, US overspending, along with the trade deficit it gave rise to, appears as a "solution" to a deeper problem involving excessive savings in the global economy. Thus, one could even claim that the US real estate boom was perversely functional in creating demand that forestalled the deflationary effect of excess savings. In other words, the trouble was not with global imbalances per se, but the unsustainable way they were being recycled and what they were used to finance.

Because U.S. households and banks continue to face an ongoing threat of insolvency, personal saving has been rising markedly since the crisis. The adverse effect of this on aggregate demand has, so far, been partially offset by a sharp increase in public spending (or dis-saving). Now that recovery is supposedly well underway, the conventional view calls for cutting public dis-saving so that the U.S. trade deficit can be reduced. Yet, that is a recipe for disaster—it risks even higher levels of unemployment. It also aims at returning to the world as it was before globalization, which probably cannot be achieved, unless going through an economic contraction comparable only to the Great Depression in its length and depth.

There is another way

Yet, soldiering on with more public stimulus to "jump-start" the economy, that only widens the twin deficits, is not really a viable option either. Even if the fears about a US sovereign debt crisis are wildly overblown, the fear is real and will impair the effectiveness of continued use of public stimulus. As is often the case, fear is rarely overcome by arguing that it is unjustified. More importantly, it is futile to jump-start U.S. overconsumption to lead the world economy out of its doldrums. Even if it works in the short run it simply will not be sustainable.

What other alternative is there if the US doesn't bite the bullet and shrink its economy, even if that can trigger a process of deglobalization?

The alternative is to ask how the problem of global excess savings can be addressed in the first place. In other words, what, if anything, can take the place of U.S. overspending in offsetting the deflationary effect of global excess savings today? Once the question is posed thus, the real policy challenge today can be redefined as figuring out how to put to use the U.S. financial system to recycle large dollar reserves abroad to finance development in poor countries, which will benefit everyone including the rich. The corollary of that is also the question of how to restore the system of global financial intermediation on a sound footing rather than getting rid of it. That however requires that the integrity of global monetary reserves is preserved. Given the increased threat of a precipitous fall in the value of the dollar and a disorderly descend to gold, the need for international currency reform is now more urgent than ever.

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