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Shifting the Focus: The New Political Economy of Global Macroeconomic Imbalances

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The economic crisis has shifted the emphasis in the debate about macroeconomic imbalances. Where once the attention focused on deficit countries, and the United States in particular, now it centers more on surplus countries like China. The argument is that these surplus countries have fostered the crisis through their single-minded determination to pursue export-led growth. They have also distorted their domestic economies along the way. Moreover, the deficit countries cannot resolve their imbalances acting alone. The time has come to reconsider the wisdom of export-led growth strategies both in the developing world and elsewhere. If accepted, these arguments will have important implications for how the world economy is reformed.

Some countries import more than they export; others export more than they import. That much everyone accepts. Moreover, what goes for trade goes for finance as well. Some countries receive capital from the rest of the world, while others send it out. Indeed, the money and goods move hand-in-hand. Net importers borrow and net exporters lend. The accounting for international economic relations is not up for debate. And while first-year economics students sometimes have a hard time wrapping their heads around the necessary symmetry between trade and capital flows, they can always be won over in the end.

The controversy only starts when the discussion moves beyond the accounting identities to focus on the political economy—particularly where wider systemic implications are at stake. Does it really make sense for the world's richest country to be both a huge net importer of goods and services, while also being the world's largest debtor nation? Should the world's most populous developing country supply not only a huge volume of global manufactures, but also the money to purchase them? Reasonable people can agree that some countries import more than they export, and the reverse. Where they differ, however, is over the relative merits of the alternatives.

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The purpose of this essay is to explore the contours of that political economy debate. My argument is that the current global economic crisis has sparked an important change in the normative consensus. It used to be easy to criticize net importing countries for their lack of competitiveness and self-discipline, while at the same time lauding net exporting countries for their manufacturing prowess and fiscal or consumer self-restraint. Now that is no longer the case. The net exporters are losing some of their virtue and the net importers some of their shame. External balance has become fashionable again.

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This shift in the normative consensus has significant policy implications both for the choice of national economic strategies and for the rules that govern international exchange. Historically, export-led growth strategies have predominated at the national level, at least wherever they could be successfully established. Net exporters have had a controlling influence in the design and function of international economic regimes, as well. Now, however, the balance of influence is moving the other way. Politicians and their advisors are arguing in favor of self-sustaining development, and recommending more support for domestic investment and consumption. As a result, we are likely to see more emphasis on 're-balancing' both within countries and between them.

This essay has five sections. The first sketches the conventional wisdom about macroeconomic imbalances prior to the current crisis. The second highlights a few of the anomalies that were apparent in that traditional view. The third describes some of the causes and consequences of the economic downturn. The fourth points to evidence of a change in the prevailing consensus. And the fifth concludes with policy implications that derive from this change in view.

The Traditional Political Economy of Macroeconomic Imbalances

Systemically important macroeconomic imbalances—meaning either deficits or surpluses on a country's current accounts—are a recent phenomenon. During the years of the classical gold standard, which stretched from the late nineteenth to early twentieth centuries, it was difficult, if not impossible, for a country to maintain substantial or persistent trade imbalances with the outside world. The same is true for the Bretton Woods period of the post-World War II era. If we look at the 1960s, for example, it is hard to find any major economy with a current account imbalance—deficit or surplus—that measured more than one or two percent of gross domestic product (GDP). A few countries had significant departures for a year or two, but none of them could be sustained.

The situation changed with the oil-price and dollar shocks of the 1970s, and the liberalization of international capital markets in the 1980s.

The oil price shocks revealed that it is necessary for countries to be able to finance significant external imbalances, particularly when their deficits are due to the high price of vital energy imports. Capital market liberalization made it easier for such financing to take place. The only question was how long this could be sustained. The experience of the United States underscored the significance of that answer.

The United States' current account balance fell precipitously from a modest surplus in 1980 to a deficit worth 3.2 percent of GDP in 1987. The result was the 'deficits and the dollar' debate, within which analysts (like Stephen Marris at the then-newly founded Institute for International Economics) worried that the United States' current account position would prove unsustainable and the dollar would crash, triggering a global recession.[1] In this account, the Japanese economy was in the opposite position, having moved from a current account deficit worth just over one percent of GDP in 1980 to a peak surplus worth 4.2 percent of GDP in 1986. Moreover, the developments in the two countries were symbiotic. Japan depended upon the United States as its major market for exports, and the United States relied on capital flows from Japan to finance its current account deficits. This symbiosis explains why the question of sustainability was so important for the international system as a whole. The two countries could not continue to follow these complementary trajectories forever, and once they ceased to complement one-another, both would surely fall apart.

The events that unfolded in the early 1990s were more dramatic for Japan than for the United States. A collapse in Japanese asset markets ushered in more than a decade of slow growth, falling prices, and debt deflation. Nevertheless, these events did little to change the underlying diagnosis of the macroeconomic imbalances themselves. The Japanese did poorly despite their export performance. Meanwhile, U.S. current account deficits were at least part if not parcel of the country's wider economic malaise. The combination of bad U.S. fiscal policies, low private savings, and the central role of the dollar for global commerce had put the world economy at risk. During the 1990s, the Clinton administration managed to avoid David Calleo's forewarning in *The Bankrupting of America* (1992),[2] but it was a close run thing, and the U.S. current account deficit was never eliminated.

On the contrary, the U.S. current account position veered sharply into the red again in the decade after 1997, bottoming out in 2006 at 5.9 percent of GDP. This time, however, there were three important differences when compared to the 1980s. First, the United States was hardly the only country experiencing a significant current account deficit—anymore than Japan was the only major partner running a surplus. Indeed, if we look at the variation in current account performance across any large group of advanced industrial economies, it is possible to see how steep and persistent was the rate of increase in the differences between national current account positions over time (see Figure 1).

The second distinction is found in European monetary integration. Those countries that joined the single European currency, the euro, were released from any country-specific balance of payments constraints. The

Figure 1.
Variation in Current Account Performance*

eurozone as a whole has to worry about managing its external imbalances, but the individual countries within it do not. They can all borrow freely in euros from one-another and only need to change currency (and so worry about international payments) in the context of their joint trade with the outside world. This is at least part of the reason why cross-country variation in current account performance since the late 1990s is so significant. Eurozone countries were quick to take advantage of their new-found freedom, with some smaller ones running deficits or surpluses well above five percent of GDP.[3]

The third difference when compared to the 1980s is the rise of new economic powers like Brazil, Russia, India, and China—or what Goldman Sachs analysts have immortalized as the BRICs. Even if we discount the role of smaller eurozone countries in estimating the cross-country variability in current account performance during the late 1990s and 2000s, it is still possible to show a persistent and substantial increase in the differences across countries over time (see Figure 2). This has less to do with the market adjustments resulting from the growth of trade between the industrialized and developing world than with the particular influence of Russia and China. Brazil and India are close to balance in their current account positions, recording an average deficit worth 0.4 percent of GDP for India and 1.4 percent of GDP for Brazil in the decade since 1997. Meanwhile, Russia and China have sustained significant surpluses. Indeed, as a percent of domestic GDP, China's surpluses are much greater than contemporaneous U.S. deficits (see Figure 3).

Before the financial crisis started in the autumn of 2007, much of the economic analysis of these macroeconomic imbalances mirrored the 'deficits

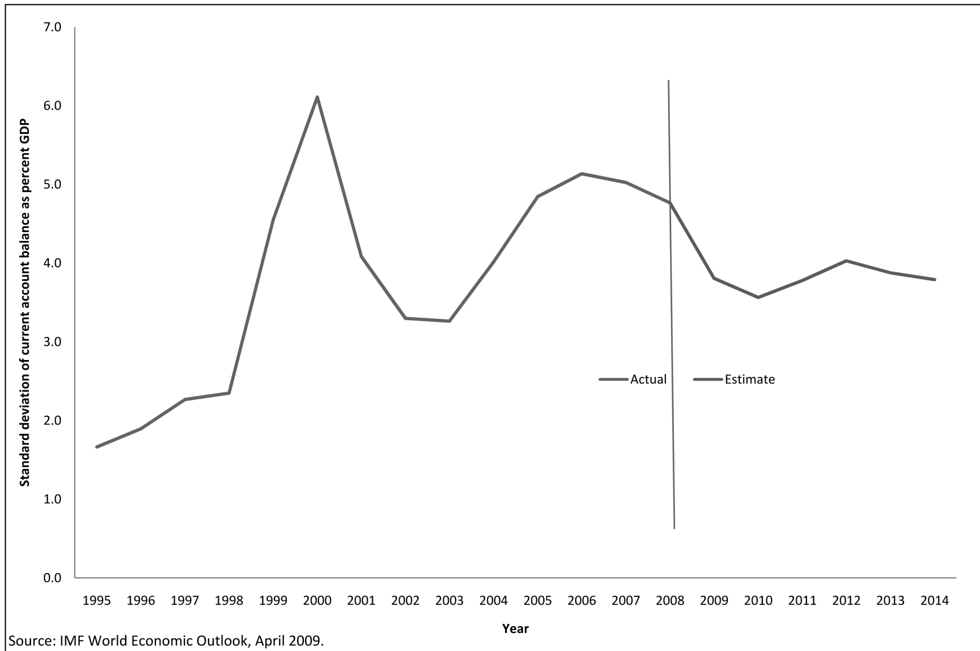

Figure 2.
Current Account Variation in G-7 + BRICs

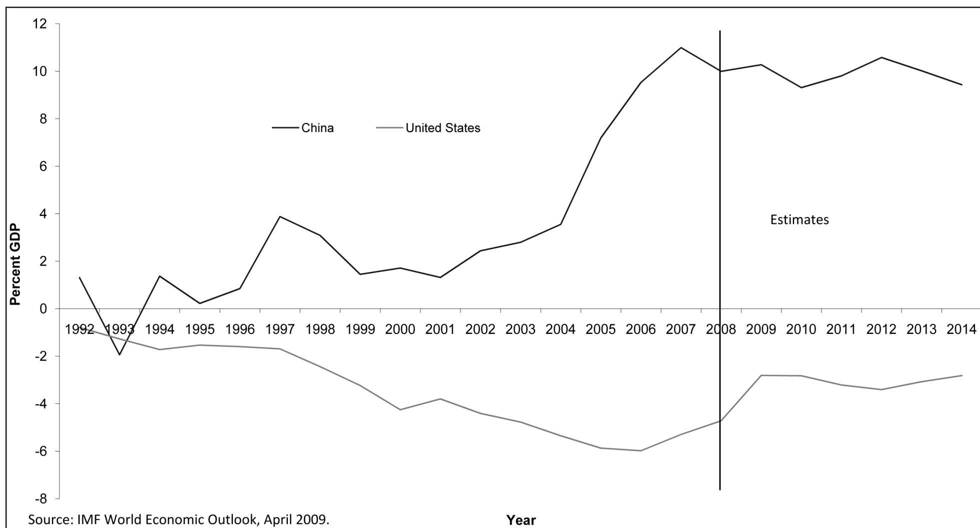

Figure 3.
Current Account Balances in the US and China

and the dollar' debate of the 1980s, with China playing the role that used to be attributed to Japan.[4] China's surpluses attracted significant attention, and yet analysts continued to focus on the size and sustainability of U.S. current account deficits, emphasizing both the weakness of U.S. domestic savings and the international role of the dollar. At some point, the argument went, the United States would face the risk that it would no longer be attractive to the suppliers of foreign credit, and China in particular. In 2007, Paul Krugman described this impending realization as a 'Wylie-Coyote' moment—where everything keeps running along until the markets see there is no floor of support and the dollar suddenly crashes.[5] Once again, the story ends with the falling dollar taking the rest of the global economy along with it. Of course some voices tried to dispel concerns that the United States would be unable to finance its persistent deficits, but most accepted that they could not be sustained forever. And, as Herb Stein first put it in a debate about balance of payments deficits in the 1980s, "if something cannot go on forever, it will stop."[6]

Some Inconvenient Aspects of Net Exports

The consistent focus on U.S. current account deficits, first in the 1980s and then again in the 2000s, was justified on many levels. The United States did run significant fiscal deficits that increased domestic demand beyond the level of production, and U.S. consumers took advantage of housing price appreciation and mortgage refinancing opportunities to increase consumption and run down their savings. Nevertheless, by focusing so heavily on the United States, the debate tended to overshadow or ignore some of the inconvenient aspects of running consistent current account surpluses. This is not to say that economists were unaware of the issues at stake. Quite the opposite. Rather, they were so focused on one particular problem (current account deficits) that they failed to embrace a much-needed perspective with regard to the perils of persistent surpluses.

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Paul Krugman's 1994 essay on the 'dangerous obsession' with competitiveness is a good example of what a change in perspective can add to the debate.[7] His central claim was that firms and countries have very different notions of competitiveness because they have very different relationships with productivity—or the amount of output generated by a given amount of labor. Firms depend on productivity to help hold down costs relative to close competitors; countries depend upon productivity to generate wealth and improve their standards of living. When firms see their competitors'

productivity grow more quickly than their own, they run the risk of being driven out of the market. The only choice is to find some way to get relative costs under control. When countries see productivity grow elsewhere, the implications are not so clear.

Indeed, far from being starkly negative, as in the case of the firm, the implications of productivity growth beyond a country's borders are more likely to be positive instead. And in this sense, it is misleading to argue that countries are somehow in competition with one another. National welfare, for example, may improve due to the availability of better imports, and may also benefit from the impact of productivity growth on the demand for goods and services abroad. By implication, relative cost control is not the most important issue and may prove to be a dangerous distraction. Finding some way to ensure that living standards continue to rise is all that really matters; whatever happens beyond their borders, governments cannot escape the importance of nurturing domestic productivity growth.

Productivity increases can come in two ways. One is to move labor from where it produces little to where it can produce a lot. When agricultural workers in China move from the rural countryside to urban factories, their productivity increases substantially, which pulls up their contribution to aggregate social welfare and purchasing power. Likewise, when manufacturing workers in the United States move from textiles to telecommunications, productivity can also increase. If each of these movements of labor takes place because of trade between the two countries, the result hardly resembles the kind of competition that occurs between firms. Instead, it illustrates the welfare enhancing effects of comparative advantage. That is why economists are so reluctant to see politicians respond to trade—and the inevitable adjustment of labor resources—with protectionist measures to achieve or sustain a relative cost advantage.

The other way to increase productivity is through investment in education, infrastructure, technology, and machines. Here the links to trade are less obvious, particularly when the focus is on export-led growth. The welfare effects of comparative advantage are still there, and there are benefits from the exchange of ideas and the diffusion of technology. But even new ideas and new technologies have to be put into practice, and that means spending money.

The problem again is the emphasis on sustaining or achieving a cost-competitiveness—primarily in response to nominal exchange rate movements that may have little or nothing to do with relative productivity growth. Exports, by definition, generate revenue in foreign currency, and net exports generate revenue above and beyond that which is required to purchase things from abroad. If this revenue is changed into national currency and brought into the domestic economy to pay for new investments, it will increase domestic inflation or push up the value of the local currency. Either way, relative costs will move against the net export position.

This is the situation that West Germany found itself in repeatedly in the 1960s. Central bankers and government ministers fought over whether a revaluation of the currency against the dollar or a relaxation of domestic

prices was the best way to go. In they end, they agreed that it would be better if exporters kept their earnings outside of the country in the hopes of mitigating the relative cost consequences of repatriating export earnings into Deutschmarks. In effect, they chose to forego new investment in order to maintain cost competitiveness. This was good for German manufacturing industries, but it came at a cost for West Germany as a whole.[8]

China faces a similar problem and has come up with a similar solution. The result has been a dramatic increase in Chinese holdings of foreign currency-denominated assets. While some of these assets belong to private actors, many (if not most) belong to the state. The central bank of China has accumulated an enormous stockpile of foreign exchange reserves and it has held these outside of the domestic economy by soaking up the resulting increase in Chinese currency through the issue of government ('sterilization') bonds. This has two different implications. To begin with, it means that China does not benefit from the foregone investment. Foreign currency-denominated assets may generate a positive real rate of return, but they do not raise productivity and so cannot contribute to an increase in standards of living. Beyond that, it means that sterilization bonds spread throughout the Chinese financial system, distorting the allocation of domestic savings and investment.[9] Moreover, so long as China continues to focus on the relative cost dimension of its export competitiveness, the volume of foreign currency-denominated assets will continue to increase.

Of course, there are many good reasons in addition to relative cost control as to why Chinese authorities have chosen to follow this course of action. The experience of the Asian financial crisis in the late 1990s underscored the importance of insuring against shocks to the balance of payments through the stockpiling of foreign exchange reserves. Meanwhile, Chinese financial markets remain underdeveloped to handle the huge volume of domestic savings, and China can only undertake so much in terms of real investment at any given point in time. Nevertheless, it is clear that exchange rate stabilization has played an important part in the government's calculus and that China is prepared to accept the continued accumulation of foreign currency-denominated assets—with all that entails—as a consequence.

Then Came the Crisis

The current economic crisis gives reason to believe that the consequences of China's current account surpluses, and the resulting accumulation of foreign currency-denominated assets, are systemic as well as domestic. Indeed, it can be argued that they contributed to the worst global recession since the 1930s.

> Did China's current account surpluses contribute to the worst global recession since the 1930s?

According to this interpretation of events, the roots of the crisis lie in the 'glut' of global savings rather than in the excess demand within the United

States.[10] The logic here is the reverse of the older debates about deficits and the dollar, because money flowing into dollar-denominated assets precipitated the crisis rather than money flowing out of them. The problem was not the sudden loss of appetite for risk or exposure to dollar-denominated assets, but the gradual loss of opportunities for generating meaningful returns on dollar-denominated investments. U.S. financial institutions quite literally did not know what to do with the vast pool of liquidity at their disposal and so they switched from investing in the real economy to speculating in financial instruments. Meanwhile, U.S. households gorged on consumption that the ready supply of credit made available and the rapid increase in asset prices could secure. The government also took advantage of the situation to run up impressive deficits without paying a premium on its interest payments. On the contrary, nominal interest rates declined and inflation expectations remained stable, meaning that the real cost of carrying debt decreased—for the government and for consumers alike. Asset prices, particularly in the housing market, increased dramatically.

The system broke down when the asset price bubble burst and financial institutions lost the ability to price their own speculative instruments. Liquidity vanished from the money market as banks refused to lend to one-another for fear that they would not get their money back. This took down the banks that were most dependent upon interbank liquidity to underwrite their lending portfolios, and it spread rapidly across the financial system and into the economy as a whole. As lending dried up, the money supply stopped growing, and economic activity ground to a halt. Worse, as U.S. households struggled to increase their savings, imports declined and the effects of the crisis spread from the United States into the developing world.

The weakness of this 'savings glut' interpretation of the crisis is that it seems too convenient and too counterintuitive. It lets the United States off the hook and hangs China instead. Profligate U.S. consumers are the victims while the frugal, hard-working Chinese are to blame. Meanwhile, U.S. policymakers failed to check the growth of asset prices and fueled record deficits as their Chinese counterparts fostered real growth that lifted hundreds of millions out of poverty. To accuse the Chinese while exonerating the Americans hardly seems fair.

Conversely, the strength of this argument derives from two broader constraints—one relating to the uneven distribution of energy resources, and the other deriving from the fact that the world economy is a closed system. China was hardly the only country accumulating vast pools of foreign currency-denominated assets; Russia, Saudi Arabia, and the other major energy exporting countries were running massive current account surpluses as well. The difference is that the trade in energy is structurally imbalanced insofar as some countries have the resources that all countries need. Energy exporting countries run surpluses by necessity and not design because if they allowed world markets to determine their relative domestic prices, they would have to witness the destruction of the rest of their industry. (This is the essence of the 'Dutch disease' that followed the Netherlands' discovery

of natural gas deposits in the North Sea.) Hence, the accumulation of foreign currency-denominated assets by energy exporting countries is less a matter of choice than necessity. China's situation, however, is different, at least insofar as its own current account surpluses derive less from necessity than from design. The fact that it was able to maintain its surpluses despite its own dependence on imported energy is even more impressive.

Yet, for China to run a surplus, the rest of the world has to run a deficit. That is what it means to say that the world economy is closed. Whatever the vices of U.S. macroeconomic policy, Chinese net exports had to go somewhere or they could not be exported, and so Chinese output growth would have to slow down. Oxford economist Terry O'Shaughnessy used to joke during the debate about macroeconomic imbalances in 2005 and 2006 that the worst thing that could happen would be that U.S. households would suddenly decide to save. Once the crisis struck, and U.S. savings began to rise, the implications for China and the rest of the developing world moved to the center of the international debate.[11]

Changing Perspectives on Export-Led Growth

The savings glut interpretation has adherents and detractors.[12] From an academic standpoint, this is what makes it an interesting debate. Nevertheless, the subtleties tend to vanish as it leaks out into the popular media and new conventional wisdom about global macroeconomic imbalances arise to replace the old along the way. This is the process that John Maynard Keynes alluded to when he talked about 'practical men' falling under the influence of economic ideas.[13] It is not an ideological conversion; it is a shift in focus instead. Where current account deficit countries like the United States once dominated the policy recommendations, the new emphasis is on net export countries like China.

The recommendations given to China form a comprehensive agenda.[14] China should stimulate domestic investment, strengthen its internal financial system, liberalize its capital markets, promote the international use of its currency, and wean itself off of its export-dependence. This is not going to be easy for Chinese leadership, which is unlikely to embrace these recommendations as a near-term agenda.[15] The United States may have to call on its European allies to help make the case.[16] But ultimately, it is the only way for China to limit its exposure to changes in the value of the dollar and to resolve the exchange rate problems associated with its present development model.[17] In any event, it is clear that, as Bergsten and Subramanian put it, "America cannot resolve global imbalances on its own."[18]

The important point to note, however, is that China is not the only country drawing this sort of attention. Rather, the focus has shifted against the export-led growth model in general. This is most evident in a recent essay by Brian Klein and Kenneth Cukier,[19] in which they make a wide-ranging attack on the Asian development strategy. They argue that by placing excessive emphasis on exports, the Asian countries have distorted the distribution of income, neglected institutional development, fueled financial instability,

and put both their economic performance and their political stability at risk. Klein and Cukier's essay does not accuse the Asian countries of causing the current economic crisis; rather, the essay is meant to warn that they may trigger the next one.

The change in perspective extends beyond Asia and developing countries to embrace advanced industrial economies in Europe, as well. Germany also depends upon export-led growth and this export dependence has become an important point of contention in intra-European and trans-Atlantic debates about the nature of the economic crisis and the appropriate policy response. The German government's position is that the crisis has American origins and that irresponsible (or greedy) bankers are to blame. When the German economy emerged from the recession in the summer of 2009, this was celebrated as a vindication of the German model and the virtues of frugality and self-restraint. That response, however, was not universally accepted. The *Economist* ran a leader criticizing Germany for its unbalanced development and arguing that "Germany's muscle-bound economy is also a victim of its exporters' success."[20] Simon Tilford took the argument a step further to argue that "a reinforced German belief in the superiority of export-led growth would be a recipe for weak growth in Germany and serious problems elsewhere in Europe."[21] And *Financial Times* columnist Wolfgang Munchau drew the argument out to its logical conclusion:

The old debate about macroeconomic imbalances gave responsibility for adjustment to the deficit countries. The new debate puts that onus on those that insist on running a surplus.

> Without an increase in domestic demand from Europe and China, there is nothing to take up the slack created by the saving of the U.S. private sector. Once the U.S. stimulus expires, and the budget deficit starts to narrow, global demand will settle at a new lower level. Under those circumstances, it is difficult to see how the world economy can return to the pre-crisis levels of growth, or even close to them. That is why we should be worrying more about global economics right now than global finance.[22]

The old debate about macroeconomic imbalances gave responsibility for adjustment to the deficit countries. The new debate puts that onus on those countries that insist on running a surplus.

Policy Implications of a New Political Economy

The open question is how this shift in perspective affects the wider policy debate. The answer is still only preliminary. The major thrust of policy will be to create incentives for countries to stay closer to balance, and to create incentives for net exporters, in particular. In the short run, those incen-

tives will be primarily rhetorical or political. By jaw-boning the net export countries, the net import countries will try to generate a broader basis of support for reform, both domestic (as in China) and international. Such efforts will likely achieve only limited success. The Chinese show no inclination to move away from their emphasis on export-led growth and neither do the Germans.

Over the medium to long term, the new change in perspective will have to develop financial incentives if it is to achieve any success. Specifically, it will have to promote reforms to the International Monetary Fund (IMF) and to the regime for providing balance of payments assistance to make support easier and foreign exchange reserves less attractive. This will sap support from the claim that consistent current account surpluses are necessary to provide balance of payments insurance, and it will underscore the importance of promoting domestic investment instead.

Still, it is worth recognizing the full implications of the fact that the world is a closed system. If net export countries stop running surpluses, net import countries will find it more difficult (if not impossible) to run deficits as well. Throughout the debate about macroeconomic imbalances, the concern has always focused on the possibility that China or Japan will stop financing U.S. deficits. Now that possibility should become the objective. There has been a shift in the normative consensus. But it does not let the United States off the hook and it will require serious effort on all sides if we are to avoid a repeat of the current crisis.

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