Conference Draft

Global Imbalances

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Over the decades there has been a debate whether or not economics is a "science," and whether any discipline which purports to describe human behavior can be a science. Sciences have "laws" that govern behavior; to what such laws are human beings subject? Without getting into essentially a semantic discussion about what is a "science," I would argue that economics does have "laws." They are not behavioral laws, but rather accounting identities which must be obeyed everywhere and at all times (apart from measurement errors); the question is not whether they are universally applicable, but whether in particular circumstances they are relevant. Three such "laws" of economics will concern us here:

(1) $X - M = S - I + (T - G)$, derived from the system of national accounts;
(2) $X - M = CA =$ Net Foreign Investment, derived from balance of payments accounts;
(3) $\sum CA$ over all countries $= 0$.

Here X is exports of goods and services, S is non-public saving, I is national investment, T is tax receipts of all levels of government, G is expenditures on goods and services by all levels of government, and CA is the balance of international payments on current account.

Since these equations always apply to every country, how can there be "imbalances?" When this term is used, as it is frequently, it usually means that the writer does not like the value of one or more of the variables. Often writers are too embarrassed to say that they do not like the observed configuration, so they call it "unsustainable." Some configurations are indeed unsustainable, as will be illustrated below, but as Herb Stein observed decades ago, if something is unsustainable, it will stop. So when something is said to be unsustainable, that is often short-hand for saying that unless we do something about it the way it will stop will be undesirable. And sometimes a configuration that is perfectly sustainable is deemed to be undesirable.

The most important global imbalance (singular) at the present time is a global aggregate demand for goods and services that falls short of the global capacity to produce goods and services. The manifestations of this are recessions in the Eurozone, Britain, and Japan; weak recovery from recession in the United States; falling growth rates in Brazil, India, South Africa, and many other countries; and

high or rising unemployment in many places. The accounting identities are all satisfied, but investment, consumption, and government spending taken together are too low, leaving resources under-utilized, i.e. wasted. A growth of exports can help an individual country overcome a recession, and often does; but by virtue of equation (3) it cannot help the world overcome inadequate demand (although a general stimulus to exports, such as is claimed for the pending Trans-Atlantic Partnership, could potentially raise investment in both parties).

The reasons for this global condition, which marks a sharp contrast from ten years ago when the world economy was booming, are complex, but the major one is probably a perception of excessive debt inherited from the boom period and subsequent financial crisis and recession of 2007-2008. Households and financial corporations built up very high debts during the 2000s, and government debt rose sharply after the crisis as a result of recession-induced shortfalls of tax revenues, financial support for financial (and sometimes other) institutions, and fiscal stimulus programs. The high debt burdens and weak balance-of-payments conditions limit the ability of many countries to take further fiscal expansionary actions. But they could be taken by countries with current account surpluses (indicating a lack of dependence on net inflows of foreign capital, via equation (2)) and that still have relatively low public debt. The list includes especially Germany and China among large countries, along with the Netherlands, Switzerland, Taiwan, and a host of smaller economies. Under its new government Japan is undertaking a program of fiscal stimulus despite its high public debt. The United States is in a special category: although it has a large current account deficit, its dollar-denominated securities are in wide demand around the world, by both private and official investors, so it also has scope for further fiscal expansion. Concretely, today's exceptionally low long-term interest rates, themselves the result of weak aggregate demand, make it an especially good time for long-term borrowing to finance desirable long-term public investments – including maintenance or replacement of aging infrastructure in the case of the United States, installation of needed infrastructure in the case of countries such as Brazil and India.

There must have been some large and unsustainable imbalances in the world economy five years ago, since a big financial crisis started in the United States, which in turn led to a worldwide recession; and a financial crisis continues in Europe. But what exactly were the imbalances? Clearly the United States was building too much housing, over 2 million units in 2005, compared with a normal needed growth of about 1.5 million units. These units were being financed in a way that was fragile, such that a weakening of housing prices led to a decline in construction and a decline in value of construction loans and especially to a decline in value of mortgages that were used to purchase the housing units, which in turn adversely affected mortgage-backed securities, which in turn led to a drying up of short-term credit to many borrowers.

But this is not the imbalance that was under discussion in international circles. The references were sometime frustratingly vague, but sometimes focused explicitly on imbalances in current accounts, and especially on the large current account deficit of the United States, which briefly reached 6 percent of GDP but was a huge number because of the large size of the American economy; and on the large current account surplus of China, which briefly reached 10 percent of its GDP, and to a less extent the surpluses of Japan and Germany.

Table 1 reports the largest current account surpluses and deficits estimated for 2012. The United States has far the largest deficit, although down substantially from six years earlier, followed at some distance by India, Britain, Canada, France, and Brazil. Deficits of Spain and Italy are suppressed by recession in those countries. The largest deficits relative to GDP can be found in Turkey, South Africa, and India. On the surplus side, Germany seems to have replaced China with the largest surplus (they are close, so this may change when the final figures are in), followed by Saudi Arabia, Russia, Switzerland, and the Netherlands. Relative to GDP, Singapore holds the record, followed by Saudi Arabia, Norway, Switzerland, Taiwan, and the Netherlands. Japan is still in the list of surplus countries, but has dropped to number eight in value, and only 0.4 percent relative to GDP. What is striking is that most countries in both columns are relatively rich, or are rapidly becoming rich. India and Indonesia are the only really poor countries in the deficit column, although the source does not report Bangladesh, Egypt, Nigeria, Philippines, or Vietnam.

Are these figures troubling? Do they represent unsustainable, or possibly sustainable but undesirable, imbalances, needing to be corrected? I do not know, but would like to introduce some words of caution about drawing such a conclusion and then attempting actions to correct the imbalances.

In a world with globalized financial markets we should expect larger current account imbalances. Globalized financial markets open new opportunities for savers, to improve yield, diversify risk, enhance safety, and gain liquidity. Many factors influence foreign investment, but among them is demographic trends. The entire world is aging, but at very different rates, and for two quite different reasons. Longevity is increasing almost everywhere, and birth rates have fallen almost everywhere, but at different rates. Increased longevity raises concerns about consumption after retirement, and can be expected to increase savings by households during their high income years, and/or lead to postponement of retirement (so far we have seen very little of the latter). Lower birth rates can lead to reduced investment, both for housing and associated expenditures by young adults, and for capital in the workplace as fewer people enter the labor force. On both counts, saving should rise relative to investment and the current account, other things equal, will improve. In contrast, countries with a rapid increase in the number of young adults will need more investment and see some deterioration in the current account.

These demographic factors might help explain the surpluses of Germany, South Korea, Singapore, and others; but on these grounds rapidly aging Spain and Italy also ought to be running current account surpluses before large-scale retirement starts. Japan is the country most advanced in the aging process. Japan ran significant current account surpluses for three decades, building up large claims on the rest of the world (via equation 2), but now (as expected on the basis of demography) the trade surplus is declining and Japanese increasingly live off the earnings of their large overseas investments; eventually, as aging continues, Japanese may begin to liquidate those investments and the surplus will become a deficit. China, also rapidly aging, is a more complicated case and will be discussed below.

Demographic factors also help to explain some of the deficits, especially those of India, Indonesia, and paradoxically the United States, which is aging much more slowly than other rich or East Asian countries and experiences a rapid increase in young adults, due significantly to immigration (see Table 2). The same can be said of Australia and Canada, both of which are rich countries which also have unexploited natural resources.

China is among the countries aging most rapidly in the coming decades, but it is also in a period of rapid urbanization, with its heavy demands for housing, for urban infrastructure, and for providing the rapidly growing urban work force with structures and equipment. These factors all raise investment requirements relative to more settled societies. Thus both household saving and investment will be high, with the net effect on the current account unclear. Also, China does not permit residents to invest freely abroad, so it is not integrated fully into the global capital market, denying savers opportunities for investment overseas.

Even if, despite these considerations, it was thought desirable to reduce current account imbalances, there would be a serious problem of coordination in doing so. By equation (3), current account deficits cannot be reduced significantly without also reducing significantly the surpluses (or increasing other deficits). By equation (1), these changes can only be brought about by changing investment relative to saving, including the public sector. It is very challenging to make the necessary changes smoothly through international coordination, e.g. by agreement in the G20, given the complexities of public decision-making in most countries and given our ignorance in many countries about how to influence private saving and investment. The main instrument for coordinated action is thus government budgets, plus some influence through monetary policy on interest rates (in the United States, mainly on home construction), and on exchange rates.

China has some distinctive features. It is widely recognized, not least by the Chinese government, that China needs to "rebalance" its economy – concretely, away from its dependence for growth on exports and export-related investment, toward household consumption and government consumption on behalf of households. Possibly excess housing construction is also a concern. So long as the Chinese economy was relatively small, and emerging from a period in which China was little engaged with the world economy, its exports could grow rapidly, and indeed they grew in dollar value at 17 percent a year 1980-2010. China is now by value the world's largest exporting country, and it can no longer grow its exports at such a rate, continuously raising its share of world exports. This rate of growth is no longer sustainable; if China does not take steps to slow it down, the rest of the world will. Already Chinese products are the largest target for anti-dumping duties around the world. In future, to a first approximation Chinese exports will be able to grow only as rapidly as world trade grows, perhaps 7-8 percent a year in dollar terms. Thus Chinese export growth must slow down significantly, and with it the investment associated with that growth. Growth in consumption must fill the gap if China's overall growth rate is not to fall significantly.

Conceptually, some of the steps that would facilitate this rebalancing are relatively easy to identify:

1) Permit, even encourage, wages to rise.
2) Pay those with deposits in state-owned banks higher interest rates, on which there is now a low ceiling imposed by regulation.
3) Increase government spending on activities directly beneficial to households, especially health care and education; public pensions could also be increased, and their scope widened.
4) Appreciate the currency more rapidly, to reduce the competitiveness of exports and to make imports for consumption less expensive. The exchange rate is now controlled by the government.

There are potential objections to each of these actions. Higher interest rates on deposits will put financial pressures on banks that face in future a sharp rise in non-performing loans. This could be mitigated by permitting lending rates also to rise, which would have the incidental effect of discouraging some housing construction; or by recapitalizing the banks, which will probably be required at some time in any case. More government spending on health care and education, except for higher pay, would perhaps require additional skilled personnel, which cannot be created quickly, but could be created over time by steering greatly increased university graduates in those directions, e.g. through higher wages. It would also enlarge the budget deficit, although the central government of China, with relatively little outstanding debt, has more room than many countries for fiscal expansion. In any case the impact on the deficit could be reduced by requiring profitable state-owned enterprises to pay higher dividends or increased taxes to the central government. Effluent charges could also be introduced, to reduce air and water pollution and greenhouse gas emissiions.

Appreciation of the currency will slow and perhaps even reverse the flow of labor into the export sectors. But that is what rebalancing requires. Service industries would expand with ever greater household consumption, and on average they are more labor-intensive than are the export sectors, so total growth in urban employment need not suffer. Appreciation of the rmb will also relieve pressure on the Peoples Bank of China with respect to monetary policy, making it easier to execute anti-inflationary monetary policy when that is required.

Home construction for investment by buyers can be discouraged by introducing property taxes and a capital gains tax on any profitable sales. These should have been introduced some time ago.

Policy changes that hurt some people are never easy. But China has shown a greater capacity than other countries to do so in the past, particularly with respect to land acquisition for public purposes or development. The social role of the Chinese Communist Party is to decide the best course of action for the future of the country and then push it through a compliant National People's Congress, compensating those who are hurt from the high social gains.

Of course, equation (3) continues to apply. China cannot reduce its current account surplus unless other countries reduce their deficits (or increase their surpluses). By equation (1), they must increase their savings relative to investment, including the public sector. Much of that is already going on in Europe with budget austerity being imposed on several countries, and where even Germany, with

its already large current account surplus, is striving to meet its constitutionally required balanced budget a year early, in 2015. And President Obama's forward-looking program for the United States would on its projections reduce the US federal budget deficit from 7.0 percent of GDP in 2012 to less than 3 percent by 2022. This target, which ceteris paribus implies an increase in national saving, will be easier to meet if China succeeds in its economic rebalancing away from exports toward domestic consumption.

Table 1

Table 2