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Global Imbalances, National Rebalancing, and the Political Economy of Recovery

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INTRODUCTION

When the leaders of the Group of 20 (G20) major economies met in Pittsburgh at the end of September 2009, the topic of "rebalancing" the world economy was high on the agenda. The final communiqué's first substantive commitment was "to work together as we manage the transition to a more balanced pattern of global growth."[1] There were good reasons for this focus. Global macroeconomic imbalances—massive borrowing by some countries and massive lending by others—drove the financial boom and bubble that eventually burst into the current crisis. There is now nearly universal agreement that such imbalances cannot be sustained, and that the former deficit and surplus nations need to move toward macroeconomic balance.

However, rebalancing requires a fundamental reorientation of some of the world's major economies, a reorientation that will lead to major economic, social, and political tensions. Foreign borrowing by the deficit countries fed an orgy of consumption that was wildly popular so long as it continued; but the accumulated foreign debt that has resulted will now begin to impose sacrifices that will be just as wildly unpopular. Nations that have relied on foreign borrowing to fuel government and household spending will have to cut back drastically. They face a reduction in real wages, in consumption, in the standard of living. At the same time, nations that have relied on exports as the engine of economic growth will have to figure out how to power their economies without relying on foreign markets. These political economies dominated by powerful export interests face fundamental challenges to those interests, as their export orientation may no longer be sustainable.

In deficit and surplus nations alike, the attempt to adjust to a new international economic reality will almost certainly lead to major conflicts within nations and among nations. What are these conflicts likely to be, and what do they say about prospects for the future? For guidance, one turns to history and theory. First, this paper reviews some of the extensive historical record on how the world economy, and the countries within it, has attempted to redress macroeconomic imbalances. Then it explores what theory says about the adjustments necessary to rebalance, and how this is likely to play out in national and international political economies.

IMBALANCES AND REBALANCING PAST

What one now think of as "global imbalances," sustained current account surpluses and deficits, are as old as the modern global economy. Previous experiences with international borrowing and lending make clear how hard it can be for governments to manage rebalancing without losing domestic support for involvement in the world economy. Some of the most revealing experiences come from the interwar years, when a previous era of global capitalism came crashing down—in part because of problems that flowed from global macroeconomic imbalances.

For generations in the late nineteenth and early twentieth centuries, the world economy was tightly integrated. In this first era of globalization, the world grew more rapidly than it ever had, in an environment of general macroeconomic stability. Despite seventy years of success in confronting periodic crises, however, this integrated global economy did not make it through the interwar years.

Both the cohesion of the world economy, and its ultimate collapse, depended upon political factors. While markets themselves might be self-regulating, an open world economic order is not: it requires that the governments of the principal economies cooperate actively and consciously, especially in times of crisis. And this cooperation in turn relies upon domestic support for a global economy. No government could make the sacrifices necessary to collaborate with its trading and financial partners without firm domestic political support for these endeavors. And without domestic support for policies to maintain international economic cooperation, the world risked—and indeed experienced in the 1930s—a downward spiral in which attempt after attempt at international collaboration failed.

The principal global macroeconomic imbalance of the 1920s was between a great power in continual and very substantial deficit, and a rising power that financed that deficit. The first country, Germany, ran deficits for largely political reasons. Its weak governments had to pay reparations to the victorious belligerents, finance reconstruction, and satisfy massive social demands. So Germany borrowed very heavily from abroad, largely from the United States, and this borrowing helped fuel a consumption boom that, among other things, dampened some of the underlying social tensions that beset that country's Weimar Republic. This was no small matter: without American financing to sustain the dynamism of the German economy, Weimar social and political instability might have caused serious problems for the rest of Europe.

There was no inherent technical or economic problem with German deficits and American surpluses. But there were political problems, for there was no real enthusiasm for the relationship on either side of the Atlantic. The German people resented the subordinate position defeat had put them in, the reparations they were forced to pay, and the social disruptions caused by the settlement imposed upon them. On the other side of the ledger, although there were plenty of Americans willing to lend to Germany, the American public, in this heyday of American isolationism, rejected any official involvement of the United States in European political or economic affairs.

The German-American financial relationship rested on weak political foundations, as neither country was really prepared for the implications of the capital flows. The United States was not willing to provide an open market for German goods that would facilitate debt service, or any government measures to deal with eventual financial distress, and the Germans were unwilling or unable to make the sacrifices necessary to provide prompt debt service.

In a 1932 presidential campaign speech, Governor Franklin D. Roosevelt emphasized the contradictions of the incumbent Republican government's international economic policy, comparing it to the fantasy world of *Alice in Wonderland*:

> A puzzled, somewhat skeptical Alice asked the Republican leadership some simple questions:
> "Will not the printing and selling of more stocks and bonds, the building of new plants and the increase of efficiency produce more goods than we can buy?"
> "No," shouted Humpty Dumpty, "The more we produce the more we can buy."
> "What if we produce a surplus?"
> "Oh, we can sell it to foreign consumers."
> "How can the foreigners pay for it?"
> "Why, we will lend them the money."
> "I see," said little Alice, "they will buy our surplus with our money. Of course these foreigners will pay us back by selling us their goods?"
> "Oh, not at all," said Humpty Dumpty, "We set up a high wall called the tariff."
> "And," said Alice at last, "how will the foreigners pay off these loans?"
> "That is easy," said Humpty Dumpty, "did you ever hear of a moratorium?"
> And so, at last, my friends, we have reached the heart of the magic formula of 1928.[2]

The magic formula failed as soon as recession hit the United States and Europe in 1929, and both Americans and Germans turned inward with a vengeance. The United States enacted the infamous Smoot-Hawley Tariff in June 1930—a move that certainly made it that much harder for its German debtors to earn the money needed to service their debts to Americans. As the Depression deepened, so did American absorption with the demands of the country's own dire domestic conditions. Almost immediately after assuming the presidency in March 1933, Franklin Roosevelt took the dollar off gold and engineered a substantial devaluation. Three months later, Roosevelt effectively broke up the London Economic Conference, probably the last hope for international cooperation, by insisting on the primacy of national measures to combat the crisis.

The crisis hit Germany even harder, and within a few months the country collapsed into social disorder and political unrest. Eventually the Nazis took power, on a platform that included rejecting the country's international economic commitments. And, indeed, Hitler's first major economic initiative after taking power in January 1933 was to declare unilaterally that Germany would not pay its foreign debtors. Ironically, Hitler waited until after the collapse of the London Conference to make official this first step on the Nazis' road to extreme economic nationalism and aggression.

The U.S.-Germany connection was the largest, most prominent, and eventually most disastrous interwar macroeconomic imbalance, but there were many others—that is, there was a lot of international lending at the time. And in instance after instance, attempts to implement—or to avoid—macroeconomic adjustment led to massive political and economic upheavals. When the governments of debtor nations attempted to impose the austerity measures necessary to continue to service their debts, they met with powerful resistance. Either they acquiesced and stopped paying their creditors, or they were overthrown—or both. The nearly universal result was that countries almost everywhere turned inward toward economic nationalism—or, if outward, toward aggression and predation. Nazi Germany was only the most prominent example. Over the course of the 1930s, virtually every debtor nation in central, eastern, and southern Europe turned toward virulent forms of economic nationalism, often with an implicit or explicit fascist bent. The debtors of Latin America, too, turned inward, although here the political complexion of the turn away from the world economy varied from left-leaning (as in Mexico) to right-leaning (as in Brazil). In country after country, the previously predominant "internationalist" interests gave way to new "nationalist" coalitions.

Macroeconomic imbalances, and the turmoil that the eventual rebalancing can bring, have been common in more recent times as well. Latin America in the 1970s and early 1980s, and East Asia in the early 1990s, ran up yawning current account deficits and massive foreign debts in an atmosphere of general economic euphoria. In both instances, borrowing typically fed a very popular expansion in consumption, and in finance, real estate, and other services, which eventually led to a bubble in some or all of these sectors. Each cycle ended in collapse and forced rebalancing, with dramatic effects. The Latin American debt crisis of the 1980s forced economic adjustments that were so drastic as to undermine most incumbent governments—including some of the world's most entrenched dictatorships, as in Brazil and Argentina. In the 1990s in East Asia, too, the expansion was overwhelmingly popular, while the contraction that began in 1997 led to political upheaval almost everywhere, and the collapse of one of the region's longest-standing dictatorships in Indonesia.

Then there was Argentina, which over the past 150 years has probably gone through more cycles of borrowing boom and bust than any other nation. The country embarked on its latest roller coaster ride in the early 1990s, with the adoption of a currency board tightly linking the peso to the dollar. As money flooded into the suddenly bankable country during the middle and late 1990s, Argentines were overwhelmingly enthusiastic about the debt-financed consumption boom that ensued. Though many observers warned that the imbalances were not sustainable, any politician who suggested that the currency board be abandoned was committing political suicide. When the financial merry-go-round eventually did stop, the result was nationwide riots, five presidents in two weeks, the biggest default in history, and a national economic collapse that was extraordinary and unprecedented even by Argentine standards.

The interwar and more recent experiences with macroeconomic imbalances reveal some important things that are of contemporary relevance. The symbiotic surplus-deficit relationships—that is, foreign borrowing and lending—are popular in the upswing, but the adjustments necessary when it comes time to rebalance can be most difficult. Domestic hostility toward the adjustment process can force governments toward policies that impede international cooperation, or even exacerbate international conflict. When borrowing ends in crisis, countries can turn inward in ways that can make it extraordinarily difficult to strike bargains at the international level.

It is not inevitable that the problems of adjustment and rebalancing will lead countries, and the world, down so unappealing a path. Some aspects of the aftermath of the debt crisis of the 1980s in Latin America provide a counterexample to the dreadful experience of the 1930s in central and eastern Europe. While the crisis led to political and social turmoil, it also set off a wave of economic reform and renewal. Latin American countries could no longer rely on debt financing and had to promote exports, while their currencies collapsed. In much of the region, the result was the rise of large and powerful export sectors very interested in international economic affairs, willing and able to support international economic engagement. These new export-oriented groups were major supporters of such things as the regional trade agreements that have flourished since the early 1990s.

These lessons are important and relevant, for what have come to be known as macroeconomic imbalances are central to globalized financial markets. More integrated capital markets mean more capital flows, more imbalances. And this is not a bad thing: savings should flow from surplus to deficit countries. To the extent that international financial markets function, there will—and there should—be countries in deficit and countries in surplus.

Political difficulties arise when it comes to the distribution of the adjustment burden. As the popularity of a borrowing boom turns into the disaster of a financial bust and debt crisis, thorny questions about winners and losers come to the fore. There are hundreds of examples of just how difficult rebalancing can be; and these serve as a warning of just how much conflict may be expected as the world adjusts to a new macroeconomic reality over the coming years.

THE POLITICAL ECONOMY OF REBALANCING TODAY

The global imbalances that were central to the sources of the crisis, and whose resolution will be central to the aftermath of the crisis, have powerful domestic political economy effects. The run-up to the crisis, as capital flowed from surplus to deficit countries, was associated with the prominence of particular groups and sectors in both sets of economies. The surplus countries were dominated by their export industries—that, of course, is where the surplus is coming from. But this, in turn, meant that resources were being reallocated away from consumers and the non-tradeable sectors.

For thirty years, the Chinese government has based its economic growth strategy on ever-increasing manufactured exports. Those whose livelihoods have depended on export markets—

provincial authorities, coastal regions, state and local enterprises, foreign investors—have been central players in the country's political economy. So, too, have other East Asian export powerhouses, such as South Korea and Taiwan, bound their fortunes tightly to the fate of their manufactured exports. The pattern is not unique to developing countries. Germany and Japan, too, have powerful export interests that have been central both to these nations' economies, and to their political economies. All of these strategies were encouraged by the United States' enthusiastic consumption binge, which included an insatiable thirst for imports.

And, indeed, deficit countries were the mirror image of this, as the capital inflow primarily benefited consumers and the non-tradeable sectors. As capital flowed in and the price of non-tradeables rose, there was an expansion in finance, insurance, real estate, and services more generally. Meanwhile, tradeables producers were weakened, especially as the capital inflow led to a surge in imports. Borrowing fed spending sprees in the United States, the United Kingdom, Spain, and elsewhere, with much of the spending going to imports, and much of the rest going to financial services and real estate. The American real estate bubble was only the largest—but not the most extreme—example. In Spain, another deficit country, housing prices tripled over the decade to 2007, at the end of which one job in seven was in construction; at the peak of the boom, more houses were being built every year in Spain than in France, Italy, and Germany *combined*.

Eventually, as the inevitable rebalancing takes hold, borrowing nations must reduce their deficits and lending nations their surpluses. The deficit countries have to wean themselves from foreign borrowing, and to service their debts. During the borrowing spree, the deficit countries consumed more than they produced and invested more than they saved; now they have to produce more than they consume and save more than they invest; they also have to increase exports and reduce imports. The domestic political economy of this sort of adjustment cannot be popular, involving as it does reduced consumption and lower real wages. While some will applaud the decline in housing prices, and the shrinkage of oversized financial sectors and overpaid financiers, much of the previous economic growth of the deficit countries depended upon these industries. Without capital flooding in, without a ceaseless stream of new building, without a continual rise in home prices to make homeowners feel richer, many of the sources of the past decade's prosperity will dry up. Now economic growth will have to depend on a reorientation of the previous deficit economies toward making belt-tightened nations more efficient, and their products more competitive. The easy days of credit-financed growth are over.

Surplus countries face problems, too, that are the mirror image of these adjustments. They have to reduce their dependence on exports, which implies that they have to increase consumption and activity in the non-tradeables sector. Exporters will be less favored than they were in the upswing, as their economies turn away from relying on the export sector and toward the promotion of consumption and domestic services. This process might be driven by stronger national currencies—almost certainly the case in China, probably the case in Germany—or from a generalized decline in the demand for imports from foreign markets now struggling with austerity. From Shanghai to the Rhineland, industries will need to find expanded markets at home, or new markets abroad—in an environment in which most of the previous sources of export demand will have strictly reduced their ability to buy foreign goods.

Rebalancing is likely to create great political difficulties within nations. Deficit countries face obvious tensions, as they confront austerity and reduced consumption. Their attempts to implement the policies necessary to deal with their accumulated debt overhang will inevitably impose serious costs on many. Adjustments in the surplus countries will not be trivial, either. It will be no minor matter for the Chinese government to oversee a reorientation of the economy toward the production of goods and services for the local market. The manufactured export sector that has been at the center of the country's economic, social, and political order for decades is unlikely to welcome anything that might displace it from its privileged position. Nor will Japan and Germany easily trim the economic and political influence of their powerful export manufacturing sectors. In all instances, rebalancing implies a fundamental change in the center of gravity of the economic, and therefore political, life of the societies in question.

The economic changes brought on by crises of this sort often lead to fundamental political change, as winners became losers, losers became winners, and political conflict ensues. Whatever becomes of these conflicts, there is little question that the countries in question will be absorbed with the domestic problems they face as they deal with the national social, political, and economic implications of rebalancing.

REBALANCING AND INTERNATIONAL ECONOMIC CONFLICT

Looking past the immediate future to the medium and long run, the world will adjust to a new reality, one in which a return to the macroeconomic imbalances that have characterized the past ten years cannot be expected. This raises important challenges to the political support for an open international economy.

As the major countries in the system undergo substantial economic, social, and political change, it will not be easy to sustain domestic support for global economic engagement. The new environment will threaten politically important interests in many societies. Interests under threat will resist the kinds of economic changes required for rebalancing and adjustment to take place, and for the major economic powers to maintain collaborative relations.

The threat is not so much that crassly nationalistic politicians will deliberately sabotage international cooperation. Instead, it is that well-meaning governments facing insistent demands from their constituents may be pulled toward policies that unintentionally harm their neighbors. This harm can then provoke hostile reactions, eventually dragging all parties concerned into bitter conflict.

Such conflict might begin on the monetary front. American policymakers are likely to face powerful temptations to address the country's problems, at least in part, with a bit of inflation and a bit of depreciation. Inflation will reduce the real burden of the country's enormous debt—both to itself and to others—while depreciation will help reduce the current account deficit. Both measures excite fear in foreigners, both by reducing the real value of their investments in American assets and by reducing their producers' ability to sell into the American market. Or conflict might emerge in trade policy. Countries desperate to increase exports and reduce imports might embark on aggressive unilateral moves to force open foreign markets, or attempts to close their own. Again, the response is likely to be hostile, and the results damaging.

Positive and constructive ways forward certainly exist, but finding them will not be easy. The structure of interests in the major societies will change as their economic orientation changes. These economic transformations, and the austerity measures associated with them, are difficult to manage and sustain without appropriate policies to smooth the path of adjustment. The more exposed citizens feel to the dangers these transformations entail, the more likely they are to attempt to shift the adjustment burden onto others, at home or abroad. One way to facilitate a more orderly rebalancing, then, would be to enhance the panoply of compensation mechanisms, social safety nets, and adjustment assistance available to those liable to be hardest hit by the process of rebalancing. Governments that provide adequate assistance to those who will be harmed, or who fear they will be harmed, by global economic trends thereby reduce the risks associated with rapid economic change. This will not be easy, especially as deficit countries emerge from the crisis with even greater debt burdens than when they entered, but the alternative to compensating the dissatisfied socially is confronting them politically—never an enviable prospect.

By the same token, national governments can facilitate positive change by making political use of real and potential supporters of international economic integration. A shift from reliance on debt-financed consumption to a more productive export capability will expand the range of businesses, workers, and regions with a stake in the world economy. Just as opening developing countries to the world economy created or strengthened more internationally engaged groups, reorienting the previous deficit economies to search out opportunities abroad is likely to create or strengthen eventual supporters of an open international economic order. Governments can look to the beneficiaries of rebalancing, and can help mobilize them to support international economic involvement.

The institutions of international cooperation can also play a role in sustaining and strengthening the environment in which collaboration among the major powers takes place. There are always temptations to pursue national policies without regard for the harm done to other countries; international institutions and international consultation can help ensure that these temptations do not lead countries down the road of international economic conflict. The International Monetary Fund (IMF) has largely focused on monitoring the behavior of developing debtor nations, on the principle that the actions of developing-country debtors can have systemic consequences. In the current setting, the more urgent task facing the world economy—and the IMF—is to monitor the behavior of rich countries, both deficit and surplus.

At Pittsburgh, the G20 recognized the need for much more consistent surveillance of national macroeconomic policies, and the IMF is expected to enhance its efforts on this front. However, the attention paid to this has been limited, even desultory, as policymakers and analysts focus on the purely economic components of rebalancing, which appears to be taking place as market forces operate to reduce deficits and surpluses alike. This misses the true challenge the world faces. It is not the purely economic features of rebalancing that will be difficult: markets will clear, one way or another. It is, instead, the political implications of the coming adjustments that will test the capacity of national governments, and of international institutions. If national leaders grasp the political stakes, they may manage the unwinding of imbalances in a way that reinforces an open international economic order. If they fail to grasp those stakes, the recent financial crisis may be a harbinger of even greater dangers to come.

Endnotes

1. http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf
2. Herbert Feis, *Europe, the World's Banker, 1870–1914* (New Haven: Yale University Press, 1930), p. 14.

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