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Financial Imbalances in the World Economy

The current account deficit of the US is by far the largest that the world has ever seen, equivalent to about 7 per cent of US national income and nearly 2 per cent of world income. The present situation relies on large capital inflows into the US, but the concentration of investment in the highest-income regions of the world is socially damaging, destabilising and prejudicial to the effective development of resources in the world as a whole. The US deficit can be contained in a less damaging manner only if the rest of the world contains its own surpluses and boosts investment in other regions.

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The current account deficit of the US, running at an annual rate of around $750 billion, is by far and away the largest that the world has ever seen. If that money figure is hard to calibrate, consider that US export income covers only 65 per cent of spending on imports – 35 per cent is imported on credit. The gap is equivalent to about 7 per cent of US national income and nearly 2 per cent of world income. Residents of other countries are financing this deficit by heavy investment in the US.

Is It a Problem?

The US deficit may not be a new phenomenon but it does have disturbing features:[1]
– the deficit has been increasing over the past 10 years and despite a real dollar depreciation of about 15 per cent over the last three years there is no sign of reversal;
– the US is now a net debtor (liabilities exceed assets) and costs of servicing the debt are compounding the current account deficit;
– The deficit has been driven by personal borrowing as well as government borrowing (that is how it became so large) and debt of the personal sector is at record levels.

It is unlikely that things will continue the way they are:
– personal borrowing has been sustained by low interest rates and rising asset values. If interest rates rise and asset prices fall, borrowing will be cut back and the slow down in spending may precipitate a recession;
– however, if borrowing continues unabated, the dollar will look increasingly vulnerable and any reduction in foreign investment may trigger a large devaluation.

The switches in trade, spending and capital flows required to

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reduce the imbalance in a less painful manner will only be effective if policies in the US, Europe and Asia are coordinated or are at least compatible. But this will not happen unless those involved form a common understanding about the necessity for policy change and agree on the objectives. The US cannot act unilaterally, other than by cutting government spending and pushing up interest rates or tax rates which will likely cause a slump. Other countries have little incentive to let their currencies appreciate and may find this hard to achieve unless they curb internal demand, increasing the risk of recession.

The current situation, which relies on large capital flows into the US, is far from ideal. Concentration of investment in the highest-income regions of the world is socially damaging, destabilising and prejudicial to effective development of resources in the world as a whole. The likely alternatives, recession and/or dollar devaluation, would only exacerbate this situation. Is there any way out?

Policies, Assumptions and Models

It is a tribute to the persuasive power of economic theory that policy-makers and research institutions in the leading countries continue to address these problems with highly artificial models that have little contact with reality as presented in statistical data. The new framework recently adopted by the World Bank fails to take account of the interdependence of income, demand, lending flows and debt stocks within and between each world region.[2] The IMF's analysis is perhaps worse since its model assumes output in each country and sector to be determined by constant-return production functions and an exogenous long-run productivity trend.[3] By assumption, and in the face of all historical evidence, the IMF asserts that world regions will return to near-optimal, full-employment paths of output and income so long as fiscal and monetary restraints are applied and price changes are allowed to work through. Thus a brief period of deflation and depreciation of the dollar will be sufficient to eliminate the US deficit – so long as governments around the world allow market forces to work through while central banks follow inflation-targeted monetary policies. If anything goes wrong it will be blamed on government intervention and insufficient competition or labour market flexibility.

It is probable that the US Treasury and the Fed attribute the US deficit to under-valuation of Asian currencies and the appetite of global investors for US assets. The US authorities appear to welcome dollar depreciation and anticipate that this will improve the trade balance without requiring significant action on their side.

A More Realistic, Open-Ended Model

If we pay greater attention to the statistical evidence we immediately see first, that the world economy follows relatively long-term patterns of development as productivity gains are generated by growth of markets and investment in technology, infrastructure, education and skill development and secondly, that trade patterns respond to the interplay of income, wealth, energy resources, market power and

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political stability.

The authors are currently developing a realistic statistical model capable of providing an informed basis for policy analysis and negotiation covering the main areas of policy – finance, trade, fiscal policy and energy issues – as they affect the world as a whole and each major country and world region.

Data for the past 30-40 years identify ongoing changes in exploitation of natural resources and geographical concentrations of industrial production that drive trade, income and financial flows. In this context the critical requirement for each country is a balance between growth potential and external trade performance. If trade performance is too weak, countries become locked into low productivity and underemployment. If trade performance is strong, countries develop a tendency to surplus that may stifle growth in other regions. Wealth and investment concentrate in the most successful areas making adjustment of trade performance a difficult process for the least-successful countries that in many cases have the greatest needs.

Inside the US

Accounts produced by the Federal Reserve and the Bureau of Economic Analysis allow us to track internal and external financial flows for the US in some detail. The salient features are that in the first half of 2005, deficits of the general government (4 per cent of national income) and the household sector (6 per cent of national income) were only weakly offset by a financial surplus of the corporate sector (3 per cent) leaving a very large savings gap (deficit of the US as a whole) covered by net capital inflows (7 per cent). In other words the rest of the world was a net lender to the US to the tune of 7 per cent of national income.

Personal borrowing has been the main force behind increases in the US deficit since the mid-1990s. Household spending has been financed by mortgage borrowing as interest rates fell and house prices increased.

The government, like others in high-income countries, has been a habitual borrower, though fiscal tightening throughout the 1990s resulted in a short-lived government surplus in the year 2000. A cut in private corporate spending at the end of that year prompted the government to boost spending and reduce taxes, pushing the budget back into deficit where it has remained up to the present time.

Private sector debt is now equal to 170 per cent of national income and government debt is 55 per cent. Overseas investment in the US has reached a total of $12 trillion, slightly more than one year's national income. Well over half is represented by direct investment and holdings of corporate bonds and equity giving foreigners a substantial stake in corporate America. Most of the remaining foreign money is invested in government securities and a small amount in bank deposits.

In the World Outside

The fact that US exports have languished while foreigners have provided the finance for US spending (and imports) has not hitherto been a major concern for other countries. Bilateral trade surpluses with the US directly add about 1.5 per cent to the income of the rest of the world, sustain production and allow most countries and regions, in particular western Europe, east Asia and oil exporters, to accumulate reserves and minimise the risk of financial crisis. With the exception of large parts of Africa, Latin America and the former Soviet bloc (the "least successful" blocs or LS for short), export-led growth has become the norm in the rest of the world ("relatively successful blocs" or RS for short).

Asia has been top of the charts throughout the recent decades but European exports have continued to grow quite fast too and per capita income in Europe has increased at about the same rate as in the US without relying on external finance. Strategically Europe appears to be in a strong position as its capital markets become integrated and Euro-denominated securities have overtaken dollar-denominated ones as a medium for international investors.[4]

Given the underlying strength of many Asian and European countries and other members of the RS group, a better balanced international economy would see reduced investment into the US and higher spending in other regions. Accumulation of US assets is a precarious strategy for foreign investors given the risks of recession and/or dollar devaluation and that tight fiscal policies in LS and RS countries are detrimental to global development and profitability. Inadequate public provision is often the cause of low levels of private investment. International institutions are not helping matters. The World Bank, set up to provide development finance in all continents, lends almost nothing. The IMF, created to provide liquidity to countries with limited reserves, has scared away its potential clients and is no longer effective as a fund.

Can the US Deficit Turn?

The difficulty of achieving changes in direction is considerable. It is necessary to overcome the reluctance of European central bankers and policy-makers to countenance anything resembling fiscal reflation and the conviction of the Federal Reserve and US policy-makers that there is nothing wrong with the dollar or the US economy.

The assumption advanced by IMF staff, although with some caveats, is that a 15 per cent effective depreciation of the US dollar will be sufficient to bring US exports and imports back into balance. Few analysts will support this view, which downplays the length of time over which an effective depreciation would need to be maintained and the implications for domestic growth. To illustrate the magnitude of the required turn-round, US exports would have to grow 3 per cent a year faster than imports continuously for at least a decade. Given that US exports have grown more slowly than imports over the past 30 years, this would be a historic break in the trend. Approaching balance would more likely require prolonged deflation as well as large-scale devaluation, giving rise to political and social problems domestically and depressing trade in the rest of the world.

There is little precedent for any major economy to have drifted into the situation in which the US now finds itself. The deflation and devaluation scenario is bad enough – protection would be worse. Given the importance of US markets to world trade and finance, it is certain that adjustments like these would seriously harm many other countries around the world.

The bottomline is that the US deficit can be contained in a less damaging manner if and only if the rest of the world contains its own surpluses and boosts investment in other regions. This requires more domestic credit creation and higher spending on infrastructure, education and energy saving. There is still a long way to go before most regions of the world come near to the developed countries in terms of per capita income, infrastructure and productive assets and they will need huge and sustained investments to get there. The IMF and World Bank should take the lead in organising short- and long-term finance for development strategies in LS areas with the cooperation of all RS regions and countries. Sustained growth outside the US will provide better opportunities for the US to increase its exports of manufactures and improve its balance on raw materials and energy.

Sharing of resources at the global level is inevitable if lower-income regions are to catch up with high-income areas, even partially, in the present century. The plus side is that trade in primary products and energy will spread income outside industrial centres and may also help to take energy-saving and renewable source strategies seriously.

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Notes

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1 Wynne Godley drew attention to most of the issues discussed here as long ago as 1999 in an article 'Seven Unsustainable Processes' published by the Jerome Levy Economics Institute. The authors have greatly benefited from his work and comments and from advice by Terry Ward but are solely responsible for errors and omissions in this paper.
2 'Economic Growth in the 1990s: Learning from the Experience', World Bank, Washington DC, 2005.
3 *World Economic Outlook 2005,* International Monetary Fund, Washington DC, 2005.
4 See Table 2 in the Statistical Appendix to the *IMF Global Financial Stability Report,* September 2005.

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