6 External imbalances: Costs and consequences of unsustainable trajectories

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Over the next several years, will recovery among the world's economies and regions portend a return to the wider and unsustainable external imbalances of the mid-2000s, or will the more sustainable path re-emerge? This chapter argues that if policymakers return to the familiar tools of undervaluing the currency and depending on the US consumer to support growth, global imbalances, resource misallocations, and future costs will all increase. What is required is a return to the dollar path pre-financial crisis and a continued focus on domestic demand, particularly in the US and China, but also on investment in emerging markets.

Before the 2008-09 financial crisis, global rebalancing was underway, albeit fragile and incomplete. The crisis itself, of course, shocked aggregate demand and raised risk aversion, together yielding a dramatic narrowing of the US external imbalance in particular (from $706 billion in 2008 to $420 billion in 2009). An important question for policymakers is:Over the next several years, will recovery among the world's economies and regions portend a return to the wider and unsustainable external imbalances of the mid-2000s, or will the more sustainable path re-emerge?

Why is global rebalancing important? In short, for both deficit and surplus nations, persistent external imbalances, and even more important, trajectories that widen those imbalances, imply demand and resource misallocations and a divorce of key relative prices (specifically the real exchange rate) from equilibrating forces. At some point, when relative prices do adjust, so too will consumption, investment, and production. Misallocations will unwind, which will be costly to wealth, production, employment, and overall domestic economic wellbeing. Adjustment costs are unlikely to be equally distributed across all countries and regions, nor within countries. Therefore, to the extent that persistent and widening external imbalances indicate underlying relative price, demand, and resource misallocations, policymakers should take note and should move toward global rebalancing.

Evidence of rebalancing before the crisis from three perspectives

Why focus on external imbalances? After all, whether in deficit or surplus, or as measured by composition of exports, imports, or financial flows, a country's external balance is not a fundamental economic force in itself, but is a manifestation of the general equilibrium interaction between many factors: domestic consumption and investment and production; prices, rates of return, and the exchange rate; international financial portfolio choice and capital flows; and fiscal, monetary, and development policies.

However, as in the parable of the blind men and the elephant, looking at external balances from several different perspectives does illuminate aspects of the more fundamental drivers over which policymakers exert some control. The three perspectives are: (1) savings and investment based on national income and product accounts; (2) international trade flows in goods and services and the current account; (3) international capital flows and holdings of financial assets (Mann 2002). Taken together, the three perspectives present a consistent, coherent, and mutually reinforcing view of the sources and consequences of external imbalances.

Looking through these lenses, before the onset of the financial crisis, evidence pointed to some progress toward global rebalancing. For example, for the US, the real trade-weighted exchange value of the dollar had depreciated nearly 25% from early 2002, and the current account as a share of GDP had narrowed from its high of nearly 6% in 2005-2006 to less than 5% as of mid-2007. The domestic savings-investment lens showed a more mixed picture, with less adjustment. household savings still hovered near 0-1% of GDP, and the fiscal deficit had turned from narrowing through 2006 to widening again, to close to 2% of GDP by the end of 2007. On the other hand, international capital flows of more than $2 trillion remained robust across all types of instruments, and easily 'over-financed' the current account deficit (Mann 2008, 2005).

In other parts of the world, some efforts to rebalance also were apparent. For example, in China, the renminbi peg was loosened in mid-2005 and had appreciated 12% against the dollar in nominal terms . China's net exports were diversifying toward Europe as well as to the US. On the other hand, over that time period, China's current account continued to widen from about 7 to 11% of GDP (even more dramatic considering that the current account/GDP was less than 4% in 2004) and, whereas household consumption was growing rapidly, as a share of GDP, it fell to around 35% of GDP (from 45% in 2000) (Bergsten, Freeman, Lardy, Mitchell 2009). Even with the adjustment in the renminbi peg, China's holdings of US treasury and agency securities nearly doubled from 2005 to 2007 (US Treasury, various years).

From the standpoint of these two large economies, while some rebalancing was underway before the financial crisis, the adjustment was fragile and incomplete. Trajectories of household consumption, too much in the US and too little in China, proved resilient to change, as is generally the case for habits. Policymakers only fitfully faced the challenges of fiscal discipline and moving to a neutral monetary policy in the US and international reserves management and exchange rate policy in China. As the financial wreckage clears in mid-2010, these fundamental habits and policy issues remain key to whether global rebalancing will resume.

Consequences of persistent global external imbalances

Why does global rebalancing matter? If surplus countries willingly finance deficit countries—the co-dependency of the 2000s—is there really a problem to be addressed by policy? Codependency is stable and this apparent stability can produce policymaker and private decision-maker complacency about assessing risks (Mann 2004, 2008). More importantly, this apparently stable situation masks undesirable economic trajectories for the individual countries as well as globally: specifically, resource misallocations that damage potential growth, may imply future substantial resource transfers, and create vulnerable financial positions.

The internal mirror is one way to measure the potential cost of a persistent external imbalance. To the extent that the external imbalance is a function of relative prices measured in particular by the real exchange rate, a persistent external imbalance points to persistent resource misallocation inside the economy. Theory tells us that an undervalued exchange rate guides investment into the tradable sector (manufacturing) relative to the 'non-tradable' sector (services). Indeed, in China, the services share of urban investment fell from 63% in 1999 to 55% in 2007, while the manufacturing share of urban investment increased from 15 to 30% (Bergsten, Freeman, Lardy, Mitchell, p111). Other evidence of resource misallocations include property price bubbles in main urban production centers, a rising geographical-and-income Gini coefficient (Chen, Dai, Hou, Feng 2010), excess capacity and falling profit margins at export-driven firms, and potential for rising non-performing loans in the banking sector; as well as the falling share of consumption in GDP, already noted.

Second, the persistent external imbalance and domestic resource misallocations yield financially vulnerable international reserves. China's international reserves include nearly $1.5 trillion of US obligations, nearly all of which are denominated in dollars. These reserves represent about 30% of dollar-valued GDP (large, but down from total international reserves accounting for 43% of China's GDP in 2005 (Truman and Wong). Is this the highest value use for this wealth? Perhaps so, perhaps not. A depreciation of the global dollar of some 10% (according to Cline and Williamson as of January 2010, a 7% real depreciation brings the dollar to its fundamental equilibrium value) reduces the international purchasing power value of these reserves only some 3% of GDP—not a big deal. On the other hand, a 30% appreciation of the renminbi against the dollar (which is the undervaluation as calculated by Subramanian in January 2010) would hit China's dollar store of wealth in renminbi terms much harder.

So, also for the US, a persistent external imbalance points to unsustainable trajectories of both domestic spending and international financial obligations. The dollar relative price, along with spending habits exacerbated by domestic policies of tax cuts and accommodative monetary stance, has contributed to a systematic external deficit heavily concentrated in consumer-oriented products (and, of course, oil); net imports of consumer goods generally account for about 50% of the overall trade deficit. Once production facilities move abroad, hysteresis and pricing-to-market tends to keep them there, cementing an external deficit in consumer goods and autos that has never been offset by capital goods or services net exports.

The consequence of generations of trade deficits (systematically since the beginning of the floating rate period) is a build-up of international financial obligations of nearly $4 trillion, 30% of GDP. While not presumptive of crisis, once interest rates start to rise worldwide, the vulnerability of the magnitude and composition of the NIIP to interest changes will become apparent (Plück and Mann, 2006). Net payments abroad on the outstanding obligations, at some point, will cut into domestic consumption, investment, and/or government spending. While not a large percentage on an individual basis, on an economy-wide basis, some estimates for these payments loom rather large given that an increase in household savings of 3 to 4% (just to repay international obligations) will prolong weak GDP growth and/or an 11 to 17% shift in government spending (which is the equivalent of how much would have to be paid to foreign investors) is nowhere in US historical experience (Mann 2009).[1]

In addition to considering the costs to US domestic demand of net investment payments on external obligations, another question is, how vulnerable is the US to the foreign investor's wealth allocation decision? Important issues of risk and return, diversification, financial leverage, home bias, and flight to safety all affect foreign purchases of US assets. Moreover, it matters whether the threshold of vulnerability to foreigners' preference for US assets is measured in stock terms (i.e. as the share of US assets in the portfolio of wealth) or in flow terms (i.e. as the share of US assets purchased out of the increase in foreign wealth). By all accounts, the flow vulnerability is what might matter, at which point, either returns (interest rates) on US assets must rise, or the dollar depreciate, which is what happened in 2002 (Mann 2009, 2003). More recent calculations of foreign investor wealth and preferences suggest that, even before the financial crisis, this marginal investment threshold would again be breached around 2014.

Finally, the magnitude of the US fiscal deficit implies substantial new issuance of US treasury securities. Foreign investors hold 56% of all US Treasury securities outstanding; about 30% are held by China and Hong Kong. Therefore, China and Hong Kong hold somewhat more than 10% of US treasury securities.[2] Although the rolling global financial crisis has encouraged safe-haven investment in dollars and US treasury securities, there is a vulnerability to such a concentration of holdings of these assets.

Other countries are not mere spectators to the nature of external adjustment and policy choices by the US and China—they also face issues ranging from domestic demand and the structure of production, to exchange rate policy, to

1 The increase in household savings is calculated as 2 to 3 percent of GDP net investment income payment on the NIIP times 70 percent share of consumption in GDP. The increase in the budget position is calculated as 2 to 3 percent times 17 percent share of government spending in GDP.

2 Based on the FDI 10% threshold for controlling interest, on this basis China owns the US.

international wealth management. Given the brevity of this memo, the focus is on the largest players on the stage; but others too around the world face costs of persistent external imbalances—real resource misallocations and concentrated international financial investments.

For everyone, probably the more challenging problem is the misallocation and needed adjustment to domestic consumption, investment, production, and trade. Patterns of production and demand are slow to change, and adjustment to employment and factories probably more costly than the adjustments to wealth.

To the extent that a return to sustainable trajectories implies a return to the path of dollar depreciation, economies dependent on exports to the US and the holders of dollar-denominated international reserves will be relatively worse off. For the US, the shift toward net exports is a counterweight to the slowdown in domestic demand and the capital 'gain' on dollar denominated obligations is a counterweight to the loss in purchasing power (Mann 2005).

Prospects for policies to promote global rebalancing

Given that a return to the widening external imbalances and their associated resource misallocations and financial vulnerability should be viewed with some concern, what are the prospects for policies to promote global rebalancing? One partial-equilibrium approach is to consider only adjustment via changes in growth—a slowdown in US economic activity and a boom abroad in both cases focused substantially on consumers. At the other partial-equilibrium extreme, all adjustment could take place via movements in the exchange value of the dollar.

Based on parameters estimated in Mann and Plück (2007), an 'average' boom in foreign domestic demand improves somewhat the US trade deficit—surprisingly less than one might expect because nearly 60% of US exports go to mature industrial countries where even robust growth is relatively modest. On the other hand, modest growth in US consumption dramatically reduces the US component of the global imbalances because of very high short-run elasticities of consumer demand. With regard to exchange rate changes, estimates using the exchange rate scenario in Truman (2005) confirm that the significant real dollar adjustment, if broad-based to include all Asian currencies, shifts US consumer spending dramatically away from those imports and raises and shifts US exports away from Europe toward Asian markets.The total shift in net exports could be some 7% of GDP.

A combination of a return to the dollar path pre-financial crisis, and a continued focus on domestic demand, particularly private and public consumption in the US and China, but also domestic plant, equipment, and software investment in emerging markets are needed. If policymakers return to their familiar playbook—undervalue the currency and/or depend on the US consumer to support export-dominated GDP growth—global imbalances, resource misallocations, and future costs all will increase. Near term growth will be at the expense of sustainable and balanced long-term growth.

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