PART 3: What are the lessons from previous attempts to rebalance the global economy?

8 The history of tackling current account imbalances

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There is today a substantial consensus that large current account imbalances are at the root of macroeconomic problems. But, as this chapter reminds us, the history of policy-induced current account reversal looks like a poisoned chalice. The lesson of the past clearly indicates that a more sophisticated approach is required rather than exerting massive pressure for exchange rate adjustment and looser monetary and fiscal policy.

As in the 1930s, there is today a substantial consensus that large current account imbalances are at the root of past macroeconomic problems. In the 1920s, it had been a question of large surpluses in France and the US, with deficits elsewhere, especially in Central Europe and Latin America. The deficit countries were pushed into adjustment by deflation, while there was no similar pressure to expand in the surplus countries, with the result that the asymmetric adjustment created a worldwide deflationary pressure.

The consequences of general deflation during the Great Depression were so severe that devising mechanisms to prevent a recurrence were at the heart of postwar institutional designs. The necessity of tackling the problem was central to the design of the IMF. IMF facilities would be used to smooth adjustment in deficit countries; but there was also a "scarce currency clause" that required action by a country running a persistent surplus. Such calculations occurred not simply on the global level, however. The Treaty of Rome (1957) establishing the European Economic Community also specified in Article 104: "Each Member State shall pursue the economic policy necessary to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while ensuring a high level of employment and the stability of the level of prices."

In practice, the idea of devising institutional mechanisms for changing policy and correcting surpluses was very difficult to realise. The "scarce currency" clause was never used, as at the beginning it would have required actions against the US, the largest member of the IMF and clearly the most powerful country in the world. IMF rulings that currencies were under-appreciated were made against Sweden and Korea in the 1980s, but never against the major countries that were at the center of discussions of adjustment in the 1970s and 1980s, Germany and Japan.

The major test cases that people regard as precedents for the problem of Chinese surpluses concern the two countries whose strategy of growth through the development of a powerful export sector is widely regarded as providing a

model for development elsewhere, especially in Asia. The surpluses look smaller than those of China today (Germany's current account surplus reached a peak of 4.8% in 1989; and Japan's stood at 4.3% in 1986); but they posed substantial problems for other industrial countries, who believed that both the major export economies were deliberately undervaluing their currencies in order to achieve export advantages.

A substantial German surplus began to appear in 1967. It was regarded as a problem only in part by the US, since the surplus could finance US deficits that might emerge as a consequence of the Great Society reform program and of the costs of the war in South-East Asia. But Germany's neighbours, especially France, were worried about the apparent German undervaluation.

An attempt to renegotiate exchange rates and achieve a revaluation of the Deutschemark at a G10 meeting in 1968 in Bonn proved to be a disaster. It was that experience that prompted the EEC Commission, and in particular the Economic and Financial Commissioner Raymond Barre to develop more concrete proposals for European monetary cooperation (and which eventually led to the 1970 Werner Plan for European monetary union). On February 12, 1969, Barre presented his own report, which started with some quite specific lessons from the November 1968 debacle. "Tax measures adopted by Federal Germany and France in November 1968 also show clearly that there can be no lasting harmonisation of indirect taxation unless economic policies are better coordinated to reduce imbalances."

Japan also developed a current account surplus from 1968, and it ballooned out in 1971 and 1972. Forcing Japan to tackle the surplus was the agenda behind President Nixon's unilateral suspension of gold convertibility on August 15, 1971, and of the exchange rate changes at the Smithsonian G10 meeting in December 1971, when a new parity system was devised. But there was no immediate correction, and the Japanese surpluses only disappeared in 1973 (the surplus had increased in 1972).

By the mid-1970s, Germany was once again running very substantial surpluses, and was pushed to correct them on both the European and the global level. The most dramatic instance of such pressure to act as a global "locomotive" came at the 1978 Bonn G7 Summit meeting, where Japan, which also had substantial surpluses ($16.54 billion in 1978, when the German figure was $9.16 billion). In both countries, the international pressure was used explicitly in internal debates to justify controversial fiscal and monetary expansion. By 1978, the Japanese government deficit reached 7.3% of GDP, while the German figure was much lower at 2.1%. When inflation surged in 1979 and 1980, the governments were vulnerable, and the international cooperation mechanism seemed to be discredited.

The third major episode of international pressure on Japan and Germany to take action against surpluses occurred in the framework of the G5/G7 Finance Ministers' meetings in the mid-1980s, between the 1985 Plaza and the 1987 Louvre agreements. The package involved exchange rate correction, since calculations showed a considerable currency undervaluation, but also a combination of fiscal and monetary measures. Again, as in the late 1960s, the

international pressure pushed Germany into looking for more European ways of dealing with its imbalances. The German surplus quickly disappeared after 1989, and not because of international coordination, but rather from 1990 in the aftermath of the massive costs of the unpredicted reunification of East Germany with West Germany.

The bitterest legacy of the mid-1980s coordination experience was felt in Japan, where there was a large fiscal expansion after 1986 and a monetary easing. The currency appreciated very rapidly after the Plaza agreement, and GDP growth fell off. In order to respond to the slowing of the Japanese economy, and in line with continued international pressure, government deficits continued. The aftermath of the experience of intensified "international cooperation" was seen as first the bubble economy of the late 1980s and then the collapse of the bubble and the "lost decade" of the 1990s.

Clearly the "bubble" and its bursting in Japan have a more complex explanation that simply the monetary and fiscal mix of 1985-1987, but the fact that this is the most dramatic instance of international engagement to tackle persistent current account surpluses overshadows current debates about what the appropriate response to Chinese surpluses should be.

The IMF's current World Economic Outlook (April 2010) presents a substantial number of cases of adjustment in order to derive the conclusion that "policy-induced current account surplus reversals were not typically associated with lower growth." But the list of specific examples, from Japan in 1973, Germany in 1970, Japan in 1988, to Switzerland in 1978, involve experiences that are considered in the domestic debates and literature of the countries concerned to be disastrous experiences, or at least precedents that should not easily or thoughtlessly be emulated. In that sense, the history of policy-induced current account reversal looks like a poisoned chalice.

The German Chancellor of the 1970s, Helmut Schmidt, felt that the process that began in 1978 in Bonn had undermined and eventually destroyed his government. His verdict on the process of seeing the world simply through the lens of current account imbalances is interesting: "There are bad exaggerations around when each views it through national spectacles. One side prattles about an inflationary community, the others, English and Italians in particular, prattle about a deflationary community which would be accomplished there and would disrupt their whole national economy."

The debate between debtors and creditors in the international economy swings dangerously between two different ways of assessing legitimacy: power and morality. What irritates debtors is often that the creditors present their position as being fundamentally more virtuous: the Greeks are said to have excessively high pensions, excessively early retirement ages, and too may extra months' salaries, while the Americans engage in consumer binges on the never never, financed in ever more ingenious ways. The creditors point to generations of Confucian or Protestant teaching on the virtues of thrift.

When history is thrown into the mix of arguments, the result can be explosive. Many people in Beijing will read the survey in the IMF World Economic Outlook as an invitation to follow Japan on the path to economic stagnation. That is not

a helpful message to send in the current state of the world economy. The lesson of the past clearly indicates that a more sophisticated approach is required rather than exerting massive pressure for exchange rate adjustment and looser monetary and fiscal policy – especially in circumstances in which China, like Japan in the late 1970s or mid 1980s, is already running substantial budget deficits.

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Harold James is a Professor of History and International Affairs in the History Department of Princeton University, and Professor of International Affairs in the Woodrow Wilson School. He studies economic and financial history and modern German history. He was educated at Cambridge University (Ph.D. in 1982) and was a Fellow of Peterhouse for eight years before coming to Princeton University in 1986. His books include a study of the interwar depression in Germany, The German Slump (1986); an analysis of the changing character of national identity in Germany, A German Identity 1770-1990 (1989) (both books are also available in German); and International Monetary Cooperation Since Bretton Woods (1996). He was also coauthor of a history of Deutsche Bank (1995), which won the Financial Times Global Business Book Award in 1996, and he wrote The Deutsche Bank and the Nazi Economic War Against the Jews (2001). His most recent works are The End of Globalization: Lessons from the Great Depression (2001), which is also available in Chinese, German, Greek, Japanese, Korean, and Spanish, and Europe Reborn: A History 1914-2000 (2003). Forthcoming publications are: The Roman Predicament: How the Rules of International Order Create the Politics of Empire (2006) and Family Capitalism: Wendels, Haniels and Falcks (2006; also available in German). In 2004 he was awarded the Helmut Schmidt Prize for Economic History, and in 2005 the Ludwig Erhard Prize for writing about economics. He is Chairman of the Editorial Board of World Politics.