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The implications of large current account surpluses and deficits (their summation globally is referred to as the level of global imbalances) for the stability of the global economy has been a highly researched area of economic analysis and has frequently been the focus of policy discussions at both the national level and in multilateral discussions. Generally it has been concluded that at moderate levels global imbalances are not undesirable, as they reflect the movement of capital from geographical areas, where its return (and thus contribution to economic output) is low to geographical areas where its return is higher. However, when imbalances become too large it can lead to foreign exchange crises as the sustainability of current account deficits becomes problematic. Keynes recognized that the development of global imbalances and how they were being resolved was a critical component of the dysfunctional international monetary system that existed during the pre-World War II period. More recently, the rather large level of global imbalances that developed in the years prior to 2007 have often been raised as one of the fundamental underlying causes of the global financial crisis of 2007-2010. The argument being that the excessive savings by China and the oil exporters led to an excess level of savings which led to: 1) low interest rates and the search for riskier assets which could provide yields closer to historical levels, and 2) the increased demand for relatively risk-free assets which stimulated the financial industry to devise a way to create supposedly risk-free assets out of riskier home mortgage loans. In many ways this whole episode was a replay of the debt crisis of the 1980s. In the 1970s the OPEC producers began to run large current account surpluses which were recycled into western multinational banks; there was a limit to how much of this could be absorbed by their traditional borrowers, which led the banks to seek out and push loans to new borrowers. Increasingly these new borrowers were developing-country governments, which as sovereigns were viewed as relatively risk free, as the mortgage borrowers were similarly viewed in the 2000s. In both cases (1980s and 2000s) these supposedly risk-free borrowers which absorbed this excessive savings turned out to be not so risk free.[1]

These episodes have highlighted the global stability implications of global imbalances and as a result have led to an almost total focus on this "stability aspect" of imbalances when evaluating their implications. One issue that has received less attention however involves the global implications for aggregate demand of these imbalances. The issue was addressed to some degree during the 1970s as the OPEC balances increased, but it was generally concluded that if the financial system could recycle these in a prudent matter (which of course it didn't) that

[1] In fact Makin (1984) has pointed out that this tendency to seek out new (and dangerous) borrowers for excessive levels of new savings has been an ancient trap going back to the Medici bankers.

imbalances need not have any major implications for global aggregate demand. This recycling could involve some loss of spending; this can occur in a domestic content when increased savings leads to lower interest rates and higher money demand. However, just as a further loosening of discretionary monetary policy (or more accommodative fiscal policy) can counter this it a domestic context, a similar possibility exists in the international context.

More explicitly, when countries run surpluses, those increased reserve currency holdings are either deposited in the international banking system or used to purchase government bonds of the reserve country. In either case this lowers interest rates either directly or indirectly in global financial markets leading to increased borrowing for investment or consumption; thus a significant share of the surplus is transformed into additional investment through this channel. In the event that these lower interest rates result in the increased demand for money balances, a small share of the surplus may "disappear" from future spending or aggregate demand. Nevertheless, a slightly more accommodative monetary or fiscal policy can inject the necessary aggregate demand back into the economies where it is deficient. Thus, in this situation, the existence of current account imbalances which are maintained through currency intervention need not have any significant implications for maintaining global aggregate demand (or national aggregate demand). This is not to downplay the implications of this for financial stability, as this process can lead to the increasing indebtedness of the deficit economies and create a stability issue such as a financial or currency crisis. And as explained these stability implications have become well appreciated and have been the focus of much academic and policy analysis.

However, what has not been fully appreciated since 2008 is that once a liquidity trap develops in the economy (economies) of the international reserve currency (or currencies), there is another quite important implication for these global imbalances. The adjustment mechanism described above that recycles the demand component of these imbalances becomes inoperative. Thus the aggregate demand that disappears through these surpluses and normally reappears as investment (or consumption) in the reserve-currency economy instead simply disappears into a black hole. As a result global aggregate demand falls. More explicitly as the surplus countries purchase the government bonds of the reserve economy, it no longer has any effect on interest rates. Thus there is no automatic corresponding increase in aggregate demand. The importance of this process by which global aggregate demand is destroyed has not been fully appreciated in either policy or academic discussions. Blanchard and Milesi-Ferretti (2011) appeared to recognize this possibility but gave it limited attention in their analysis of global imbalances, perhaps because they believed in early 2011 (incorrectly in retrospect) when they were writing their article that the liquidity trap in the advanced economies would quickly disappear. Not only is it still present in 2013 but could continue to be the case for another year or two. Thus the special case of the international reserve currencies being in a liquidity trap will have existed for probably six years and will have been a significant factor in explaining the sluggish recovery throughout this period.

In addition, as the automatic mechanism of recycling demand becomes inoperative, it is also the case that the central bank of the reserve economy is unable to compensate for this through discretionary policy since it has already pushed monetary policy to the limit. An additional question concerns whether the inoperative mechanism described above is relevant for only surpluses that have resulted from central bank currency intervention (as with China) or if it equally applies to flexible exchange rate situations where the surplus is financed by private sector capital outflows (as was the case with Japan until a few months ago). The answer of course would depend on the nature of these capital flows but generally it would seem that there is little differentiation between the two situations. Clearly if the capital flows went to purchase foreign reserve countries' government bonds then there would be no difference. If the funds were deposited in a reserve country banking system then they would likely have little impact on creating new loans since presumably the banking systems already have excess reserves (being unable to lend out what funds they already have). If the private capital flows went to purchase assets, that would have no direct impact on demand but by increasing asset values this could stimulate additional demand through wealth effects. Thus it is probably the case that a surplus financed by private sector outflows would transfer some demand externally but certainly less than in the non-liquidity trap situation.

Under these liquidity trap conditions, the reserve currency government could use fiscal policy to increase aggregate demand to compensate for the loss though its current account deficit which then disappears; however, if the government has already high levels of debt or once such a level is reached, this is no longer an option.

This is in fact what has been happening over the last five years. Interest rates in all of the economies that issue reserve currencies to any significant degree have been near zero and effectively in a liquidity trap. The purchase of government debt of the advanced economies by the surplus economies has had no effect of further reducing interest rates. Initially the reserve economies increased their discretionary fiscal policies to address the collapse in aggregate demand, but as debt levels increased this option has had to be scaled back or even reversed entirely. Because of these current account surpluses, countries have been forced to use fiscal policy in order to counteract their deflationary impact and as a result their debt levels have now become problematic. Thus the excessively large current account surpluses not only helped create the financial crisis, but have weakened the recovery of the last five years and have contributed to the build-up of debt of the advanced economies as a result of both the crisis and the need to counteract the imbalances' depressing effects on global aggregate demand.

Empirically, how significant has this black hole been relative to the increased debt that the reserve economies have had to create to counteract the loss of aggregate demand. As discussed above it is not clear how to accurately estimate the loss of aggregate demand,

especially those losses that come from surpluses financed by private sector flows and surpluses based upon intervention that was not sterilized. However, the amount of sterilized intervention would appear to represent the absolute lowest amount of aggregate demand drainage since it is clear that the foreign exchange used to purchase reserve currency debt produces no additional aggregate demand, and the domestic currency used to purchase the foreign exchange is also withdrawn from circulation through sterilization. Between February 2009 and September 2013, the foreign currency holdings of the major economies increased by $4.2 trillion dollars; this amounts to about $.9 trillion a year (US Treasury, 2013). Of this $1.8 trillion or almost 43 per cent of the total was purchased by China. It is generally agreed that China sterilized most of this intervention.[2] Saudi Arabia purchased $280 billion, Brazil $174 billion, Taiwan $119 billion, Russia $98 billion,

The current narrative in many quarters is that since the level of global imbalances has declined recently from about 2.5 per cent of global GDP in the few years prior to the financial crisis in 2007-08 to just slightly below 2.0 per cent and expected to stay at about this level over the next year or two, that the imbalances are now "benign". [3] However, as discussed above nothing could be further from the truth. The surplus countries since 2009 have been taking aggregate demand of approximately two per cent of world GDP out of the global economy. In order to counteract this, the advanced economies have needed to inject a similar amount just to keep aggregate demand from declining during a period when there was need to actually increase aggregate demand. Given that the advanced economies account for about half of global GDP, this means that they have needed to inject about four per cent of their GDPs just to counter the deflationary impact of these surpluses. With interest rates already near zero, this injection has had to take the form of increased fiscal expansion. Thus fiscal expenditures equal to approximately four per cent of their national incomes have gone just to counteract the deflationary impacts of the global surpluses. This does not mean that their fiscal deficits have needed to be four percentage points greater of GDP since an expenditure increase of four per cent of GDP would generate increase taxes and be partially self-financing. However, depending on estimated multipliers, etc. it is reasonable to suggest that the fiscal deficits of the advanced economies have had to be approximately two per cent of GDP larger each year since 2009 in order to counter-act these surpluses. Given the fact that a number of countries have become debt constrained either actually or politically and have been unable to increase deficits as much as needed, the result has been lost growth and increasingly lost potential growth that will have negative consequences for perhaps decades to come. Thus these surpluses during the recovery period have been extremely costly for the world economy and will continue to be so. Current forecasts are that interest rates will be near zero for another two years in the US and Japan and perhaps much longer in Europe. Thus this significant drag on the world economy is likely to

[2] I was explicitly told this was the case in a conversation with officials of the People's Bank of China at the annual meeting of the Bank for International Settlements in 2012.
[3] See for example the recent LINK Global Economic Outlook 2014-2015.

persist for several more years. In addition this benign view of these surpluses fails to fully recognize that their recent decline is largely due to the depressed economies of the deficit economies; as such the structural nature of the surpluses and the fact that they could reappear with recovery suggest that more needs to be done to reduce them further.

In addition it needs to be pointed out that although global imbalances have declined to about 2.0 per cent of global GDP from about 2.5 per cent in the few years prior to the global financial crisis, these imbalances are still nearly twice their level of about one per cent of global GDP which had existed throughout the 1990s.

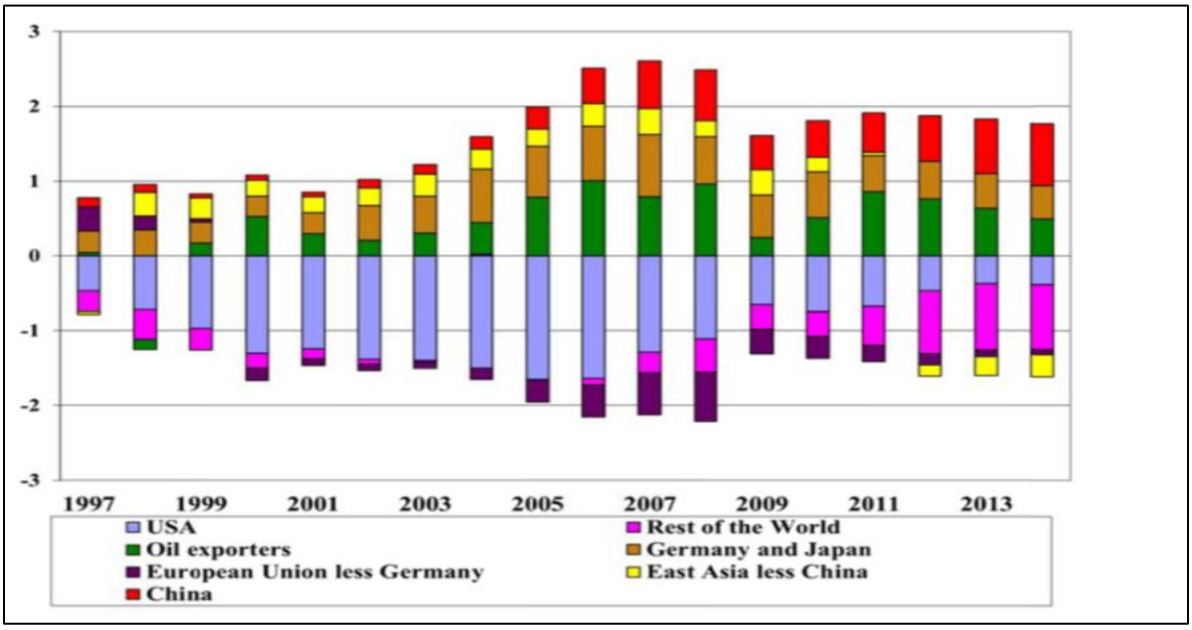
Just as the current mediocre recovery in the advanced economies has been caused to some degree by the level of current account surpluses of other economies, this was also the case in the 1930s although it operated through a slightly different mechanism. It is widely appreciated that the manner in which the French dealt with their surpluses during the 1920s was a major contributing cause of the severity of the Great Depression. France had experienced a large currency depreciation during the early 1920s which allowed it to run significant surpluses in the late 1920s and early 1930s. Instead of allowing its currency to appreciate, it maintained its low value with foreign exchange market intervention. Instead of "playing by the rules" of the gold standard and allowing these surpluses to increase its monetary base, it chose instead to sterilize this intervention. This in itself would have been contractionary from a global aggregate demand perspective, but they compounded this effect by refusing to hold currency reserves and demanded payment in gold. Between 1929 and 1933 France increased its share of world gold reserves from 7 to 27 per cent. As gold reserves fell in the reserve currency countries, this led to monetary contraction, deflation and a much more severe depression (Irwin, 2010). Therefore the current Great Recession has been similar to the Great Depression in that current account surpluses were sterilized and this drained aggregate demand from the global economy and worsened the economic situation. Luckily this time, the monetary authorities in the reserve currency countries were able to greatly expand their monetary bases despite their current account deficits.

The world economy has experienced a severe financial crisis, a quite anemic recovery and rising sovereign debt levels in the advanced economies. A significant factor in all three of these developments has been the level of global imbalances. One of the largest policy mistakes of the last several years has been the failure by policy makers in many economies to recognize that the economic "truths" that were widely accepted prior to the crisis have turned out to be false when economies are in a liquidity trap. This holds especially true in analyzing the implications for global imbalances. The normal focus on stability issues and the neglect of the macroeconomic consequences has led to a policy failure in properly addressing the implications of global imbalances, just as it has led to a failure to appreciate the importance of fiscal policy.

What is needed is increased international political pressure on surplus economies to reduce these surpluses through either exchange rate adjustments or increased domestic spending.

Table 1

Global imbalances as a percentage of world gross product



Source: Table taken directly from: UNDESA/Project LINK. 2013. LINK Global Economic Outlook 2014-2015.

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