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Global Imbalances and Global Aggregate Demand

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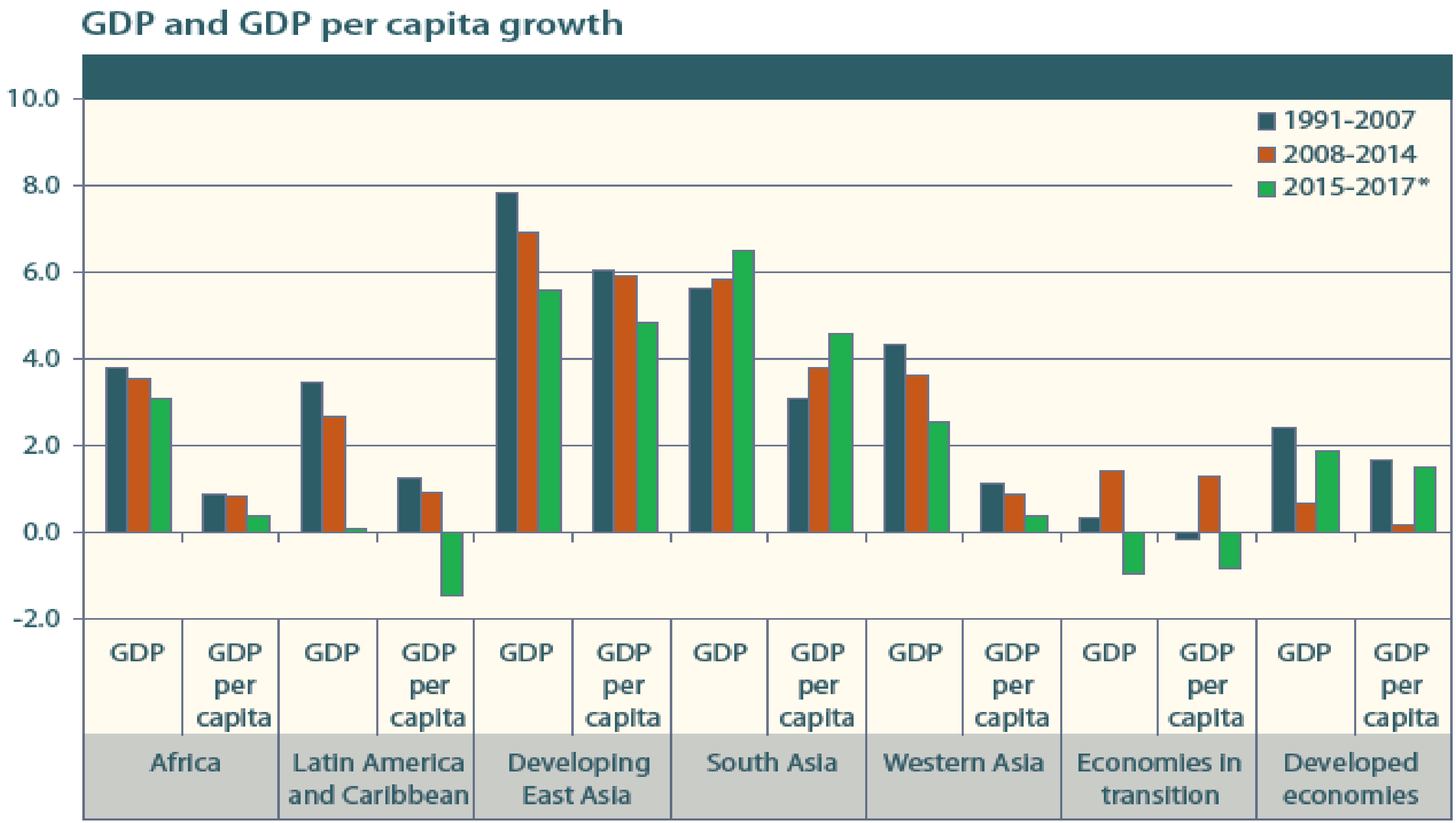
Every region of the world (except South Asia) has experienced a growth slowdown



*Includes estimates and forecasts.
Source: UN/DESA.

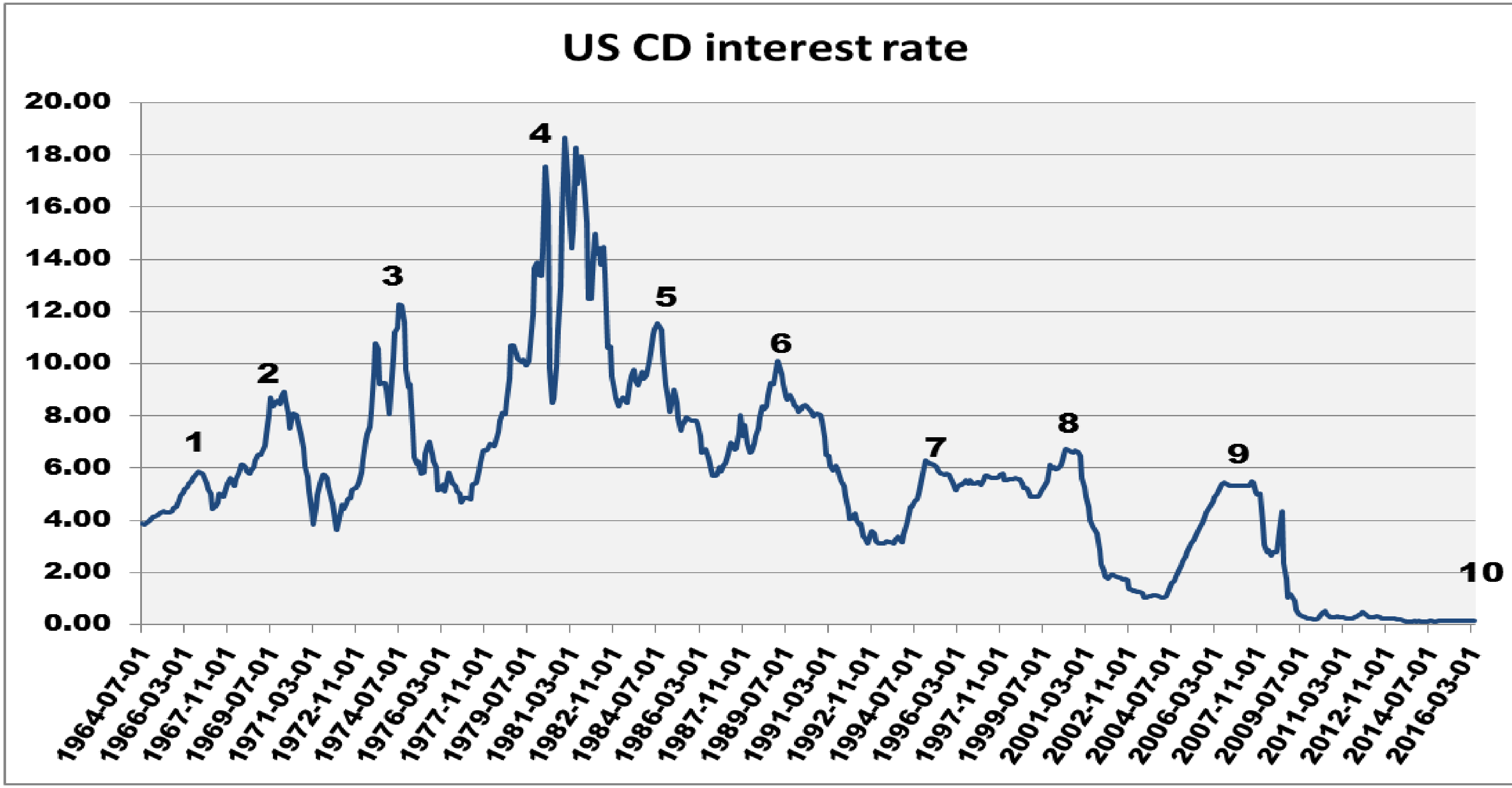
The global slowdown

- World trade is growing slowly
  - During 2012-15 trade grew at the rate of GDP growth; historically has grown twice as fast
- Inflation is close to zero in EU and Japan and only 1% in US
- Unemployment over 10% in EU; although low in US, employment participation rate is low
- Oil and commodity prices remain depressed
- 10-year government interest rates are low
  - 2% in the US,
  - 0.5% in Germany
  - 0.2% in Japan
- This suggests markets view the growth slowdown will persist for years to come
  - The specter of secular stagnation; the current situation could be more than just a long, slow rebound from the financial crisis
  - Even before the crisis there was evidence of a global aggregate demand problem, ie Bernanke's "global savings glut". Thus global imbalances problem began before global financial crisis

The US & global economy are quite vulnerable

- The real vulnerability of the US economy now is that there is no likelihood of any policy response should a greater slowdown appear.
  - Politically no fiscal response is likely and indeed a slowing economy is likely to produce a fiscal contraction as state and local spending declined
  - Although the monetary authorities could marginally reduce rates or engage in more quantitative easing, neither is likely to be very effective.
- An integrated global economy needs a global central bank. Traditionally the US Fed has given only marginal consideration to the international effects of its policies, and as a result negative international consequences have usually resulted, especially during periods of monetary tightening.

Every significant increase in US interest rates has led to some type of international financial crisis



1.Gold standard ends, 2.Bretton Woods ends, 3.Smithsonian Agreement fails, 4.Latin American debt crises, 5. South African, Chile, Mexico, Singapore financial crises, 6.U.S. savings and loan financial crisis, 7.Tequila crisis, 8.High-tech stock market bust, 9.Sub-prime housing financial crisis, 10.The next one

Global Imbalances and Global Aggregate Demand

- Global growth has been sub-par since the global financial crisis
- There has been a deficiency of aggregate demand and much of the developed world has been in a liquidity trap
- A major contributor to this slow growth and higher unemployment has been the economic drag created by global imbalances
- The “normal” automatic mechanism of recycling demand has become inoperative
- In order to compensate for trade deficits, fiscal deficits have had to be much larger; this has significant costs and may not be sustainable

Global Imbalances and Global Aggregate Demand: Policy

- Economic policy should not consider trade deficits as a minor inconvenience but as a serious vulnerability that needs to be promptly corrected
- Increased international political pressure on surplus economies is needed to reduce these surpluses through either exchange rate adjustments or increased domestic spending
- Slowing Chinese economy and lower oil prices are reducing imbalances
- The current political dialogue that has disparagingly targeted current trade policy is justified. The supposedly enlightened trade liberalization and globalization advocates are relying on trade theory that is inappropriate for current economic circumstances
- More generally, the largest policy mistake of the last several years has been the failure by policy makers to recognize that the economic "truths" 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

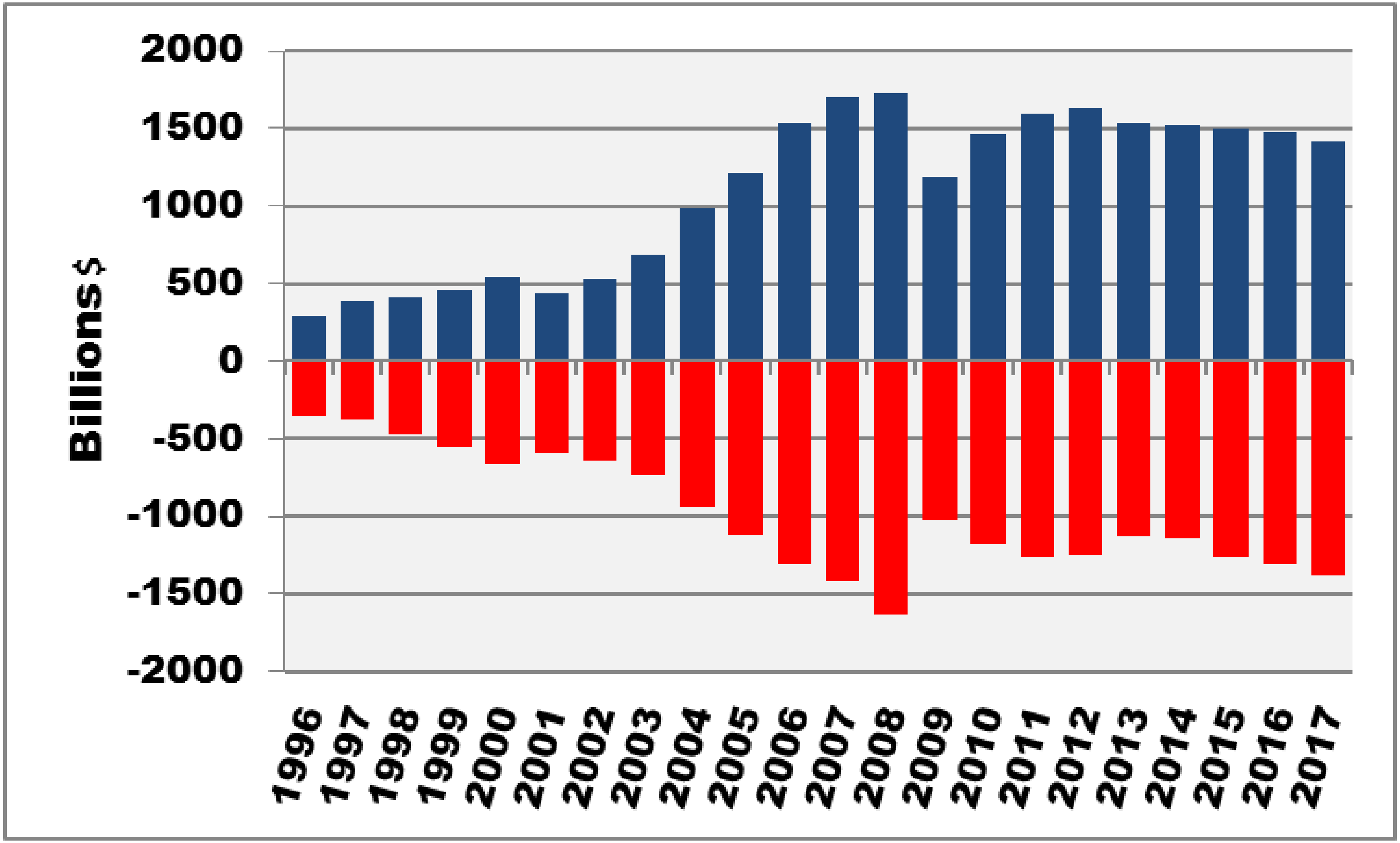
Repeat of the 1930s

- The current Great Recession has been similar to the Great Depression
  - In the 1930s current account surpluses were sterilized and this drained aggregate demand from the global economy and worsened the economic situation.
  - France which depreciated in the early 1920s then ran large 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. Between 1929 and 1933 France increased its share of world gold reserves from 7 to 27 per cent.
  - Keynes recognized that the development of global imbalances and how they were resolved was a critical component of the dysfunctional international monetary system that existed during the pre-World War II period.

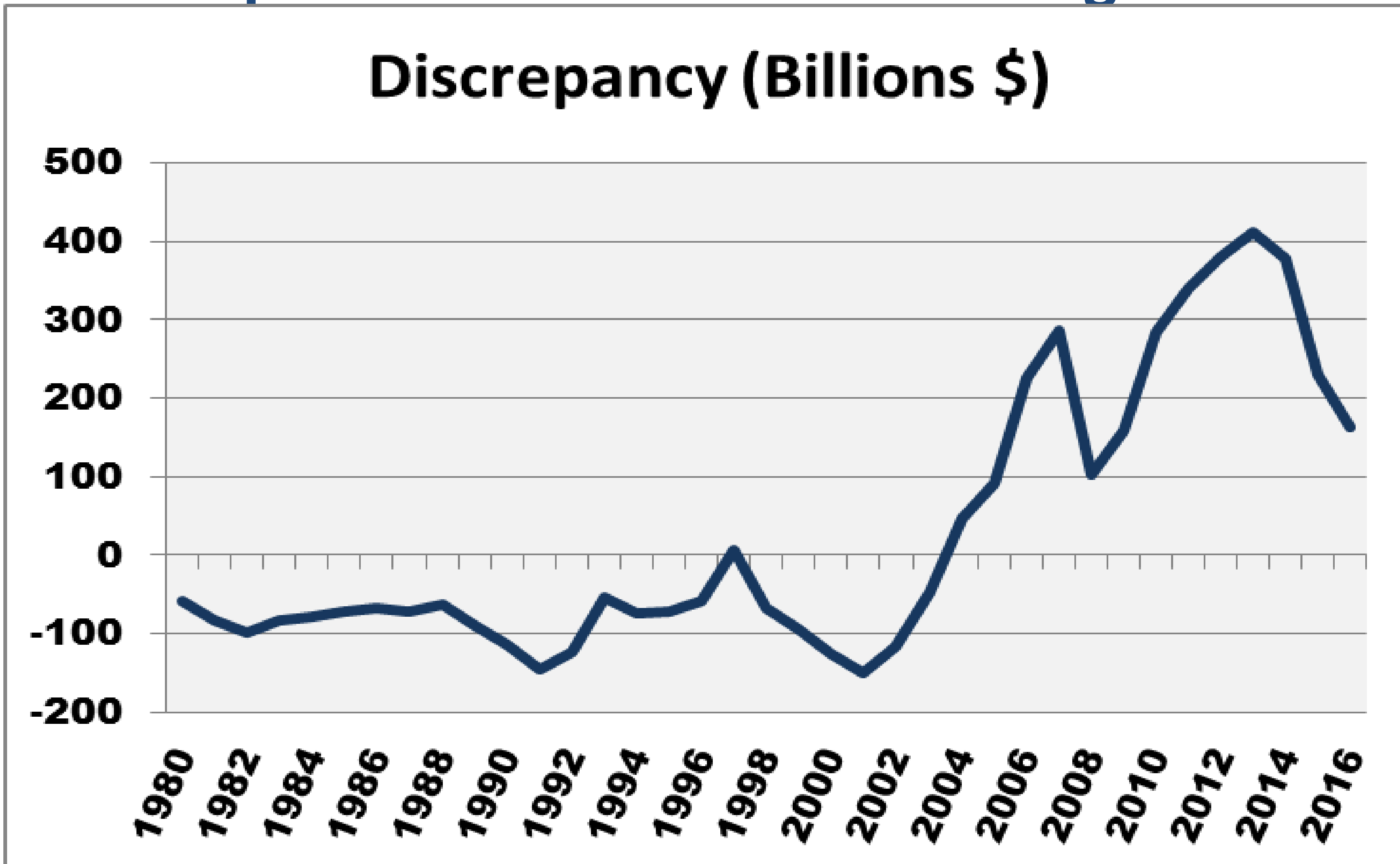
Reasons for trade surpluses

- Resource rich and aging societies want to produce now and consume later.
- The need for international reserve assets to mitigate trade and financial shocks
- Due to various market imperfections and externalities, the manufacturing sector is not as large as what is required for maximum growth. Industrial policy is an option, but can be difficult to manage, can be captured by special interests, and has increasingly come under attack by the WTO. An alternative is a devalued currency; this has been keep out of the WTO and bilateral trade agreements, and thus it has become the default industrial policy.
- In a world of deficient aggregate demand, trade surpluses import aggregate demand and spare the country from having to use fiscal deficits to generate demand.

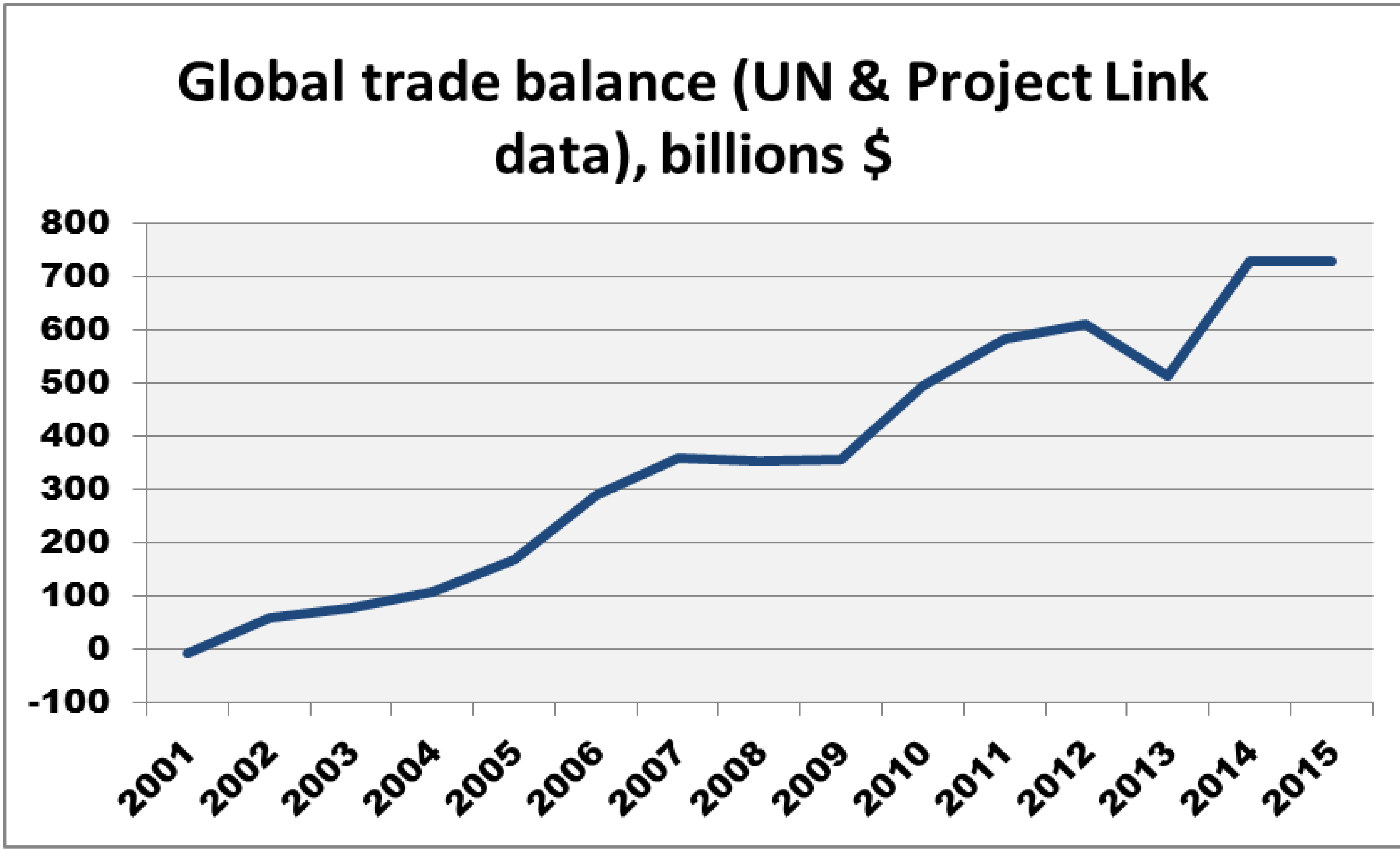
Size and Trend of Global Imbalances



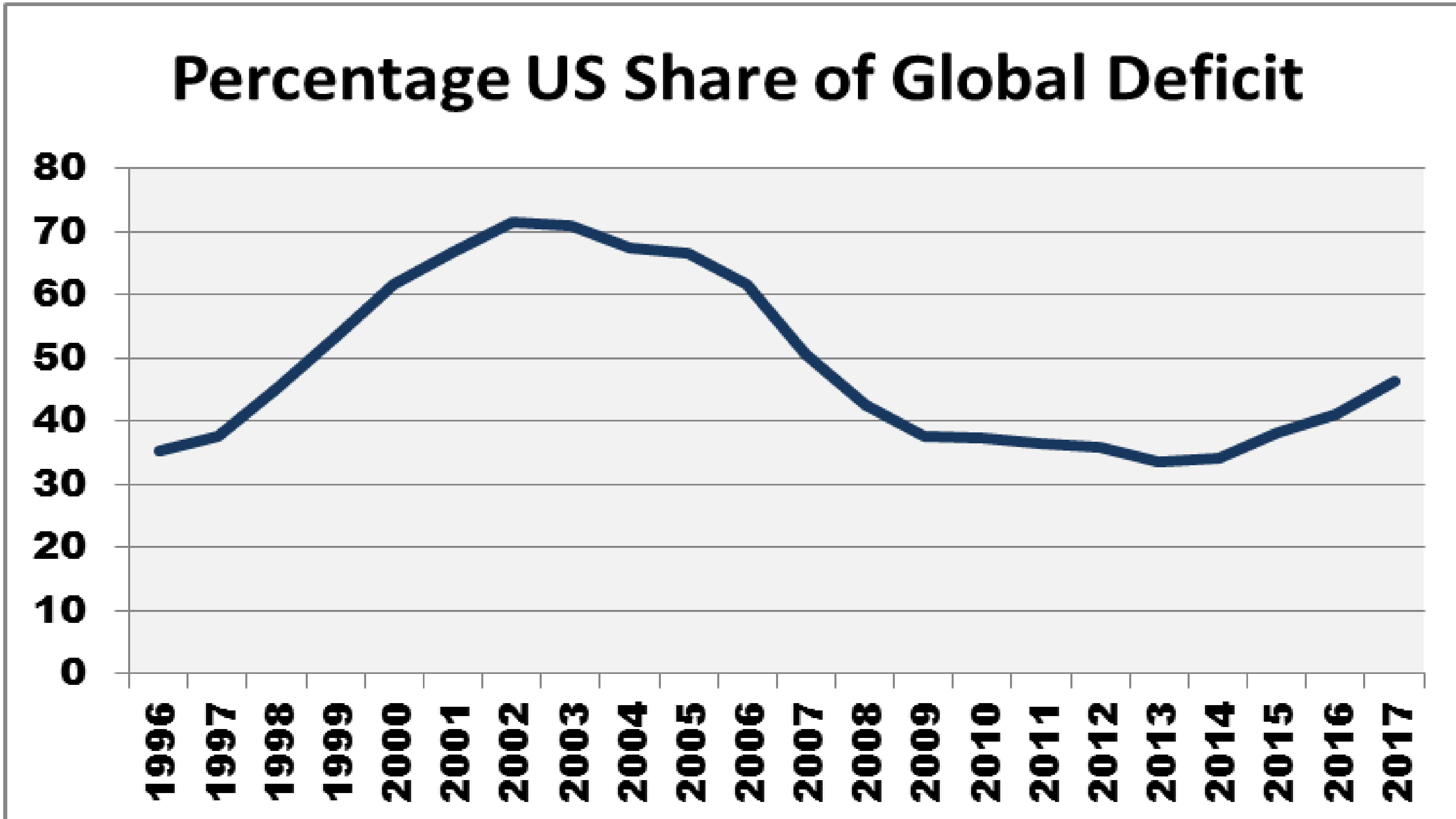
Current account discrepancy (IMF data) has shifted from an excess of deficits to excess of surpluses and become much larger



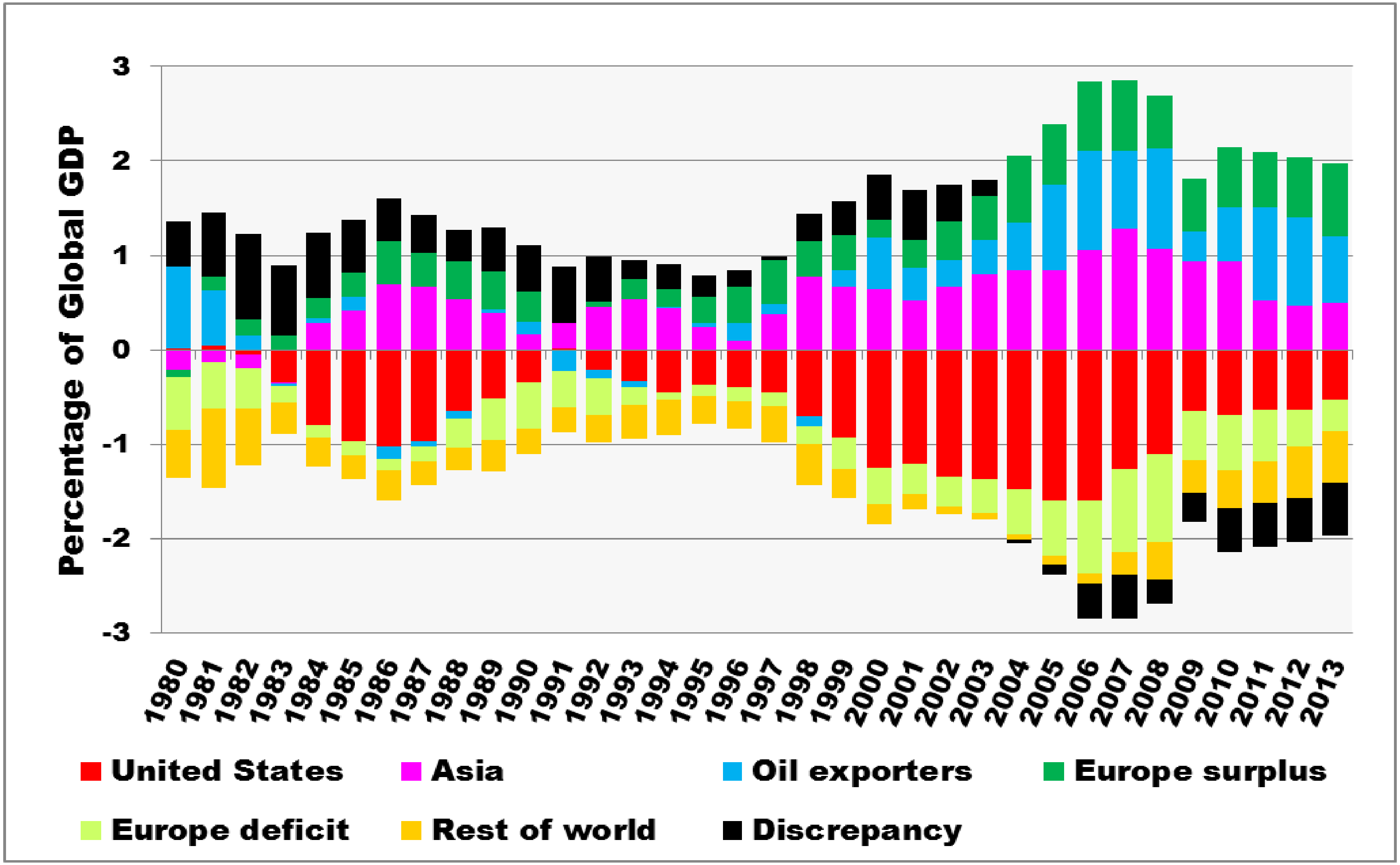
The global trade balance is even larger



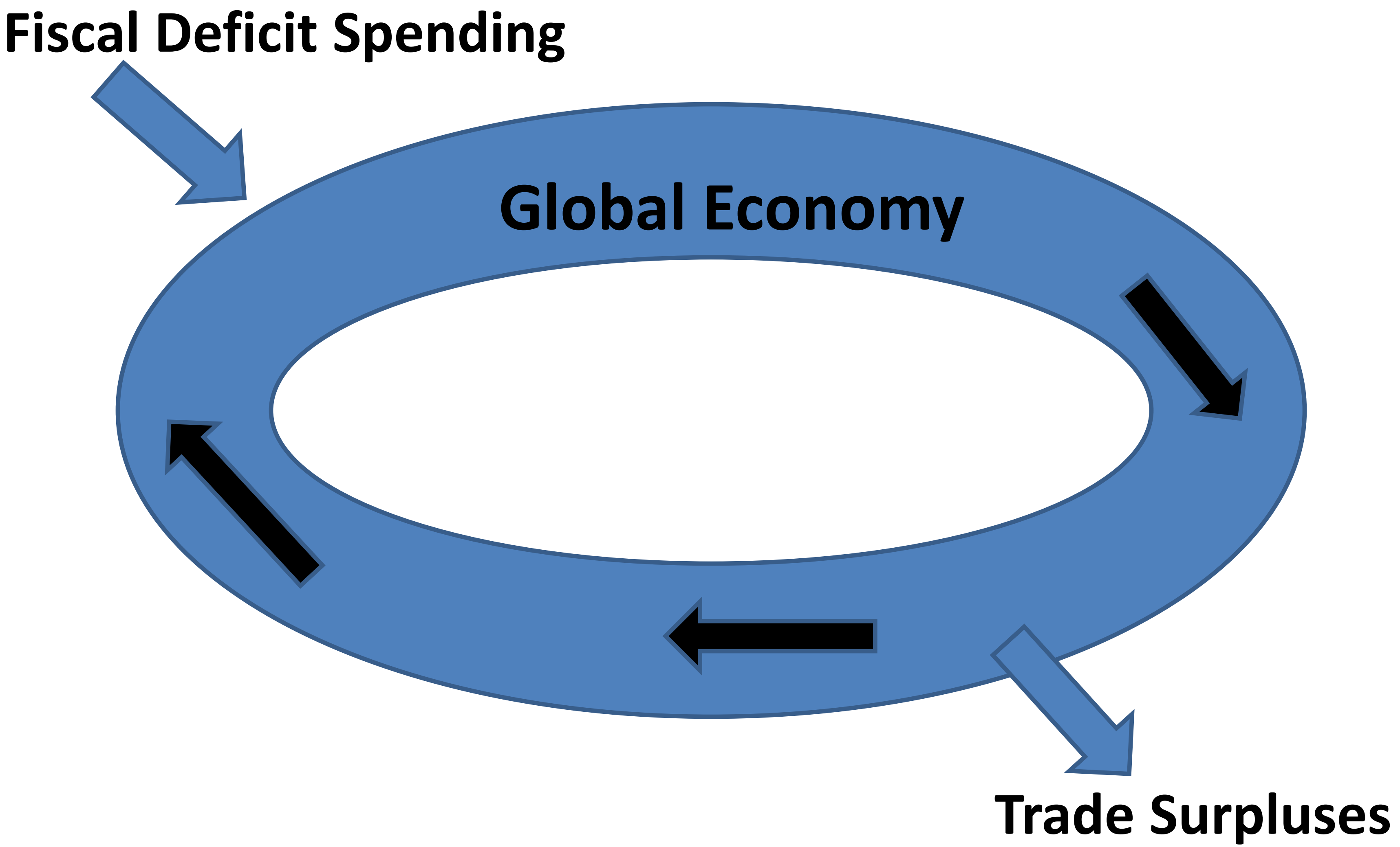
Historically the U.S. accounts for about half of global deficit



Major sources of current account deficits and surpluses



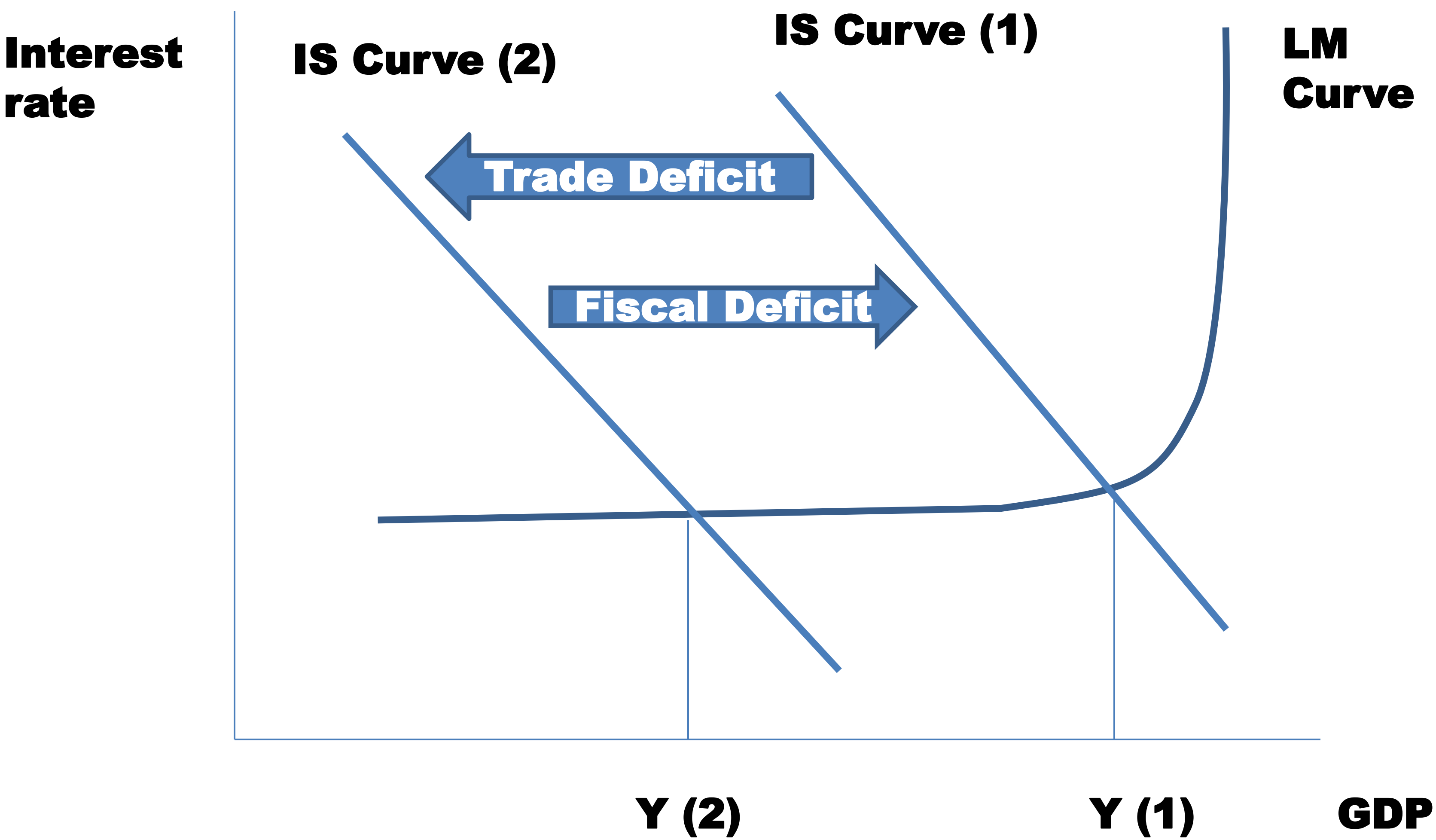
The global economy: deficit spending by US, Anglophiles, and Southern Europe are the main injections and trade surpluses by Asia, Northern Europe and oil exporters are the major leakages



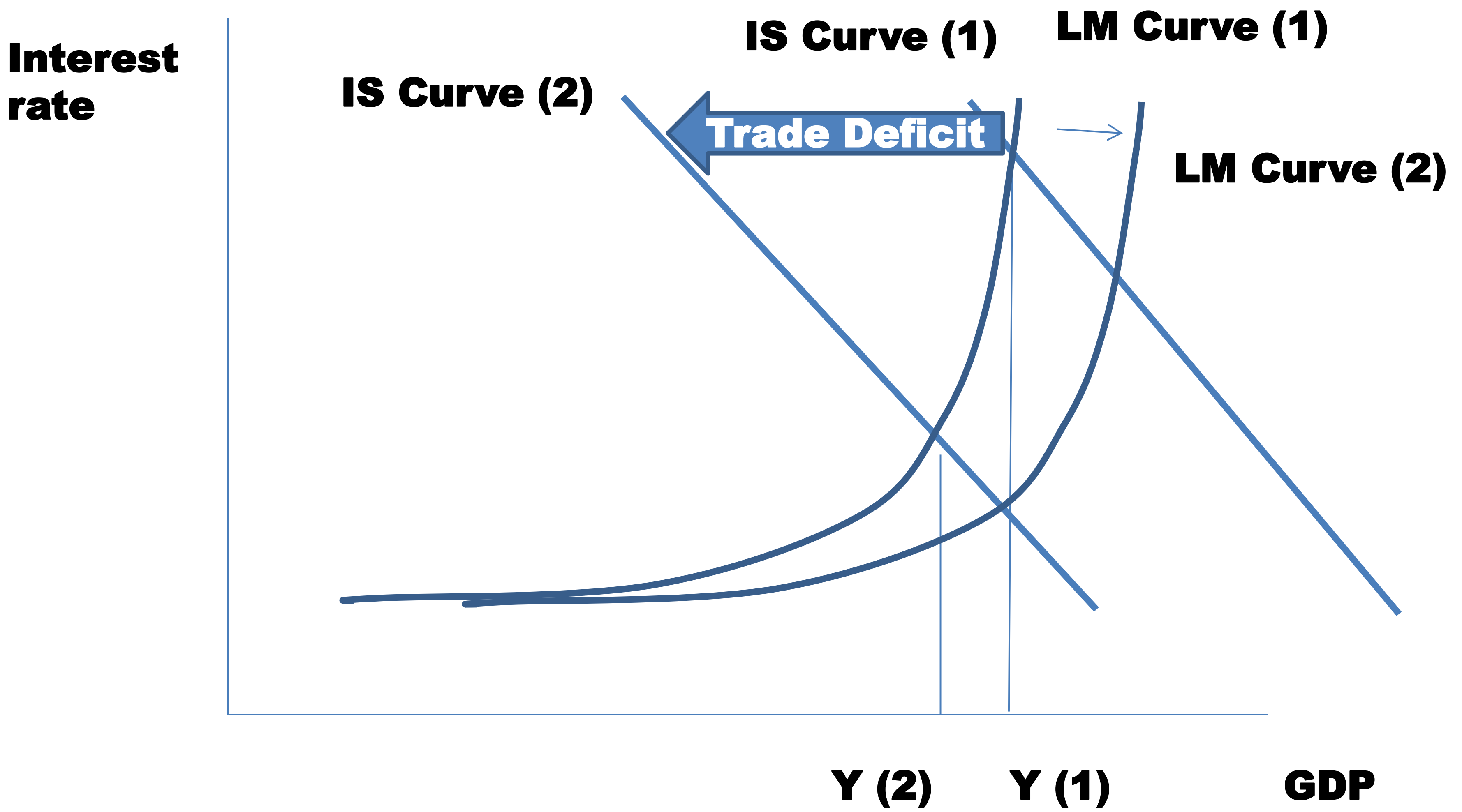
How US spending on imports disappears into a black hole

- US spending on imports from China
- Chinese exporters sell their $ to Chinese central bank
- China purchases US government debt or deposits $ in dollar financial institution; or sellers of gov. debt increase deposits in dollar financial institution
- Addition $ in financial system don't lead to any addition investment since interest rates don't fall, so just more excess reserves for the banking system
- China is able to sterilize their $ purchases thus taking demand out of the Chinese (and world) economy (so their imports don't increase

Essentially the US would be at full employment, but the trade deficit causes IS(1) to shift to IS(2); fiscal deficit of about the same amount is needed to shift IS(2) back to IS(1)



Under normal circumstances, a trade deficit causes IS(1) to shift to IS(2) which might cause a little unemployment, but that can be remedied easily with a slightly more expansionary monetary policy shifting LM(1) to LM (2). A trade deficit has little consequence.



US current account drains a significant portion of fiscal deficit; after crisis about 1/3, recently almost 100%

	US Deficit	US CA	% CA/Deficit
2008	-459	-691	151
2009	-1413	-384	27
2010	-1294	-442	34
2011	-1300	-460	35
2012	-1087	-450	41
2013	-680	-377	55
2014	-485	-390	80
2015	-438	-484	110
2016	-616	-541	88
2017	-504	-639	127

Relative size of fiscal deficits and trade surpluses

- Fiscal deficits in 2015 (IMF-general government net borrowing)
  - US-$314 billion
  - All advanced economies with a trade deficit (US, UK, France, Spain, Australia, Canada) - $491 billion
  - All fiscal deficits of all economies in the world - $1,563 billion
- Sum of all current account surpluses - $1,505 billion

Global imbalances and international reserve accumulation

- Sterilized intervention that went to purchase international reserves went into a black hole; are trade surpluses financed by private capital outflows any different?
- Global surpluses since 2009 have been about $1.5 trillion a year
- About 2/3 of global surplus goes to purchase international reserve assets. Between February 2009 and September 2013, the foreign currency holdings of the major economies increased by $4.2 trillion dollars; this amounts to about $.95 trillion a year. Of this $1.8 trillion or almost 43 per cent of the total was purchased by China; Saudi Arabia purchased $280 billion, Brazil $174 billion, Taiwan $119 billion, Russia $98 billion

Trade policy when in a liquidity trap and aggregate demand is deficient; i.e., 2009-2016(?)

- **Under normal circumstances a trade deficit for the US is of only limited significance and there is no reason for its elimination to be a high policy priority.**
- **However, under conditions of deficient aggregate demand and a liquidity trap, a trade deficit produces significant unemployment which has social costs many times the magnitude of any efficiency gain from trade. Significant reduction of the deficit should be highest policy priority even if openness or globalization has to be cut back.**
- **Although a fiscal deficit can alleviate some of the damage, it has its own costs and must be used prudently. US gov. debt has already increased from 41 to 74% of GDP since 2008.**
- **The current political backlash against open trade policies reflects what people on the ground are experiencing firsthand due to deficit unemployment effects (on top of Stolper-Samuelson increases in inequality); while mainstream economists continue to preach the gospel derived from inappropriate (full employment & real trade) models.**