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Global Rebalancing: The Dangerous Obsession

Uri Dadush
Senior Associate and Director, Carnegie International Economics Program

Summary

The current emphasis on global rebalancing—which aims to reduce trade deficits and surpluses—is misguided. Trade deficits and surpluses narrowed significantly during the Great Recession, can be financed and eased over time, and are largely the result of domestic forces—making further global rebalancing unlikely.

The obsession with global rebalancing stokes currency and protectionist tensions and diverts attention from what is really needed—reforms at home. Rather than focusing on global rebalancing, countries should concentrate more on fixing their domestic problems and expanding their domestic demand at the maximum sustainable rate.

The idea of "rebalancing" global demand, which has periodically attracted attention in recent years, is once again in the spotlight. In November 2010, for example, at a Group of 20 (G20) meeting in Seoul, the United States and other countries that run external deficits called on countries that maintain surpluses—notably China, Germany, and Japan, along with many smaller nations—to pick up the slack in global demand. This effort brought no tangible results.

But the emphasis on global economic rebalancing is misguided in any case. It diverts attention from what is really needed—reforms at home, reforms that cannot permanently be postponed by exerting pressure on trading partners. Moreover, the obsession with rebalancing stokes currency tensions, such as now exist between China and the United States and, ominously, contributes to mounting protectionist sentiment.

A major rebalancing of global demand—that is, a decrease of aggregate demand in deficit countries relative to that of surplus countries, resulting in smaller trade deficits and surpluses all around—occurred during

ABOUT THE AUTHOR

Uri Dadush *is senior associate and director of Carnegie's International Economics Program. His work currently focuses on trends in the global economy, the global financial crisis, and the euro crisis. He is also interested in the implications of the increased weight of developing countries on the pattern of financial flows, trade and migration, and the associated economic policy and governance questions.*

A French citizen, Dadush previously served as the World Bank's director of international trade and before that as director of economic policy. He also served concurrently as the director of the Bank's world economy group, leading the preparation of the Bank's flagship reports on the international economy.

Prior to joining the World Bank, he was president and CEO of the Economist Intelligence Unit and Business International, part of the Economist Group; group vice president, international, for Data Resources, Inc., now Global Insight; and a consultant with McKinsey and Co. in Europe.

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the worst of the global economic crisis in 2009. However, a long-term trend toward rebalancing is unlikely to develop. Most forecasters expect current account deficits and surpluses to remain in their present, moderate range or, as the global recovery consolidates, to widen slightly. The truth in any event is that most imbalances are not a problem in and of themselves, and can be financed and eased over time.

Nonetheless, the rebalancing dispute rages on. The G20, beginning with the United States, may soon have to make a choice: deal decisively with the profound domestic vulnerabilities that the global financial crisis exposed, or put at risk the open, rules-based trading system that has underpinned postwar prosperity.

IS THE REBALANCING OVER?

As a natural result of the international credit crunch, global demand underwent a major rebalancing during 2008–2009. In countries with large current account deficits—countries such as the United States and Spain—the housing bubbles were biggest and consumers the most extended. Thus, these nations experienced greater reductions in demand than surplus countries did. International negotiations had little to do with these shifts in private demand.

By and large, the rebalancing that has already occurred is expected to persist. Chastened households in the United States, Spain, and Greece are saving more; banks in these countries are deleveraging; and governments in many cases are retrenching. At the same time, China's new five-year plan emphasizes increased domestic demand and the development of the country's poorer western regions. Growing middle-class populations in Asia and other parts of the developing world are buying more goods.

Other considerations make further rebalancing unlikely, however. While large output gaps and high unemployment persists in the United States, Spain, and other countries with external deficits, many developing countries with external surpluses are straining capacity and are in danger of overheating. Thus, while the former want to see domestic demand revive, the latter are trying to contain it.

The advanced countries that run the biggest current account surpluses, meanwhile—although they have unused capacity—are unlikely to register high growth in domestic demand. Germany recently announced a plan to cut spending and boost tax revenues. In Japan, public debt is more than 200 percent of gross domestic product (GDP), interest rates are at zero, and previous experiments with quantitative easing have borne little fruit. Tokyo appears to have run out of options for boosting demand.

Not only is further global rebalancing unlikely, it is not necessarily desirable. To begin with, current account deficits and surpluses in the range of 3–5 percent of GDP—a range in which most large countries fall today and in which they will likely remain in the medium term—are not exceptional. They can be, and historically have been, financed comfortably and adjusted to over time. These moderate current account imbalances, and the international capital flows that are their mirror image, may reflect market-driven international differences in savings trends and investment opportunities rather than manipulated currencies and de facto protectionism.

Consider the United States, whose treasury secretary recently urged countries to limit their current account surpluses and deficits to 4 percent of GDP. America still suffers from a low household savings rate and a large fiscal deficit, but it also ranks among the world's leaders in competitiveness, governance, and business climate indicators. It has the largest and deepest financial markets. It holds the world's reserve currency. With such a low savings rate and such a favorable investment climate, the amount of foreign investment that the United States attracts—investment that is the mirror image of the country's now-modest current account deficit of 3 percent—is hardly surprising. Indeed, the United States has remained the world's safe haven for investors during the Great Recession (previous to which the country's external deficit was twice its current size). This is remarkable, considering America's position at the epicenter of the crisis. The United States has borrowed at the lowest interest rates in its history, and the dollar continues to appreciate whenever global investors get edgy.

Now consider China. Its rankings in global competitiveness, governance, and business climate are mediocre. Its capital markets are underdeveloped. Its currency is not freely convertible. Yet China's national savings rate is the highest in the world. Not surprisingly, its domestic investment rate (though exceptionally high) falls short of its savings rate, and the excess savings are invested abroad. This forms the counterpart to the country's current account surplus.

Viewed from this perspective, China's external surplus and America's external deficit are simply reflections of underlying domestic conditions. They are only bad if they are clearly unsustainable—which is not the case now—or if something is amiss in those underlying domestic conditions. If the latter is the case, underlying problems cannot be addressed by trade measures or currency interventions. Such interventions could actually make things worse—for example, by penalizing trade or raising prices for consumers, without materially altering the imbalances themselves.

NO CURRENCY FIX

During the pre-crisis boom, when imbalances were very large, the rebalancing dispute revolved around the sustainability of large trade and current account deficits. Today it focuses much more on the need to maintain global aggregate demand. Yet one thing has not changed: Countries can progress much further toward sustainable imbalances, vigorous demand, and stronger economies by addressing domestic distortions and weaknesses than they can by asking others to adjust. In this case, "What you do is what you get."

The emphasis on global economic rebalancing diverts attention from what is really needed—reforms at home.

Imagine, for example, that in response to U.S. pressure, Chinese leaders agreed to adopt a current account target—but then went much further, deciding to run a current account deficit. Imagine the government dictating that the country's savings be reduced immediately by 10 percent of GDP (approximately $500 billion). Imagine, even more implausibly, that none of this additional spending could go toward domestic products; instead, all of it would have to go to imports.

This would immediately turn China into a larger external-deficit nation, proportional to its GDP, than the United States is today. But if China's increase in imports were allocated to exporting nations in proportion to China's recent import spending, how would this enormous shift in policy affect American exports and demand? The increase would amount to just $40 billion—which would represent a 9 percent reduction in the U.S. current account deficit and a stimulus of 0.3 percent of America's GDP (equivalent to about one-ninth of U.S. fiscal stimulus measures in 2010). In other words, relying on Chinese reforms to reduce the U.S. current account deficit is like asking the tail to wag the dog.

But what about insisting that China stop intervening to hold down its currency, which it clearly does in spades, so that the renminbi (RMB) appreciates? Wouldn't that help the rest of the world, or fix the U.S. current account deficit? The short answer is: not necessarily. China and some of its direct competitors would benefit from RMB revaluation. But many other countries, including the United States, would not benefit. In fact, the U.S. external deficit might widen.

The obsession with rebalancing stokes currency tensions and contributes to mounting protectionist sentiment.

Provided that the RMB revaluation occurred gradually, without disrupting China's growth, the greatest beneficiary would be China itself, as its consumers would see lower import prices. The country's growth would become more balanced and resilient by virtue of greater reliance on consumption and less reliance on extraordinarily high investment and exports. More-balanced Chinese growth would also create positive spillovers for the rest of the world, including reductions in currency and trade tensions.

Some Asian manufacturing exporters that compete directly with China, such as Malaysia and South Korea, would also benefit from RMB revaluation. Low-income commodity exporters would generally be net losers because the prices of the many items they import from China would rise. But the value of their exports would change little, since commodity prices are set in dollars in international markets, and these countries do not compete with China in manufactured goods.

Some high-income countries, such as Germany and Japan, which export a lot to China, could see small gains or losses from RMB revaluation; their ability to increase prices for what they export to China might be offset completely by increased prices for what they import from China. And because Japan and Germany's sophisticated exports do not compete with China's exports, they would be unlikely to see a gain in export volumes.

However, countries such as Italy and the United States—which import about three or four times as much from China as they export there—would very likely lose on account of RMB revaluation, as the rise in prices for goods imported from China would dwarf all other effects. In fact, such countries' current account deficits with China would almost certainly widen permanently. All this is not meant to imply any judgment on whether a large bilateral trade deficit with China is good or bad. It only suggests that RMB revaluation cannot fix the deficit on its own. The exchange rate gets a lot of attention because—aside from instituting protectionist trade measures, which can be challenged in the World Trade Organization—it is the only instrument through which governments can directly affect external imbalances. However, both logic and experience indicate that an exchange rate cannot correct external imbalances without simultaneous changes in underlying domestic savings and investment patterns. This brings us to the real issues.

THE POLITICS OF REFORM

If current account deficits and surpluses have already declined to moderate levels, if they are largely driven by domestic forces, and if countries cannot rely on their trading partners to fix their own external imbalances, why, then, does the global rebalancing dispute persist?

To begin with, asking trade partners to buy more and sell less holds a strong mercantilist appeal—an appeal that sits well with powerful special interests, though it may raise prices for the general public. In the same way, surplus countries have strong incentives to resist rebalancing. This tension establishes the conditions for the international divisions, currency conflicts, and protectionist pressures that we see today. The potential for these conflicts to escalate is particularly elevated now because advanced countries are experiencing high unemployment, and their appetite for policies that might stimulate demand is reduced by large public deficits and debts.

Most importantly, rebalancing garners so much attention because it is the easy way out. It is easier to blame others than to confront the real issues—namely, domestic distortions that should be addressed for what they are. The four largest economies—the United States, China, Japan, and Germany—are most directly responsible for the dynamics of the global rebalancing dispute, and their policies set the tone for all other countries. How should these four nations correct their domestic distortions so as to promote their own and the world economy's sustained growth, while also defusing the quarrel over rebalancing?

The United States, which owns the reserve currency, should cease pursuing what is increasingly perceived as a policy of currency depreciation vis-à-vis the rest of the world. Quantitative easing, the plea for current account targets, aggregate export promotion initiatives, and exhortations to allow revaluation of currencies are all seen as parts of this policy. With negative net exports (that is, the current account deficit) representing less than 4 percent of GDP and domestic demand representing 104 percent, U.S. policies to stimulate demand should focus on the latter rather than the former. Against a backdrop of slow growth and stubborn unemployment, the country needs to resist an early withdrawal of stimulus. President Barack Obama was right in December to propose an extension both of tax cuts and of temporary aid to the long-term unemployed. Assistance to strapped and retrenching states and local authorities should be extended as well.

But the United States must also reassure investors and trading partners by legislating reforms to reduce spending and increase revenue in the medium term. Specifically, medium-term fiscal consolidation measures that aim to encourage household saving and also to reduce the current account deficit could include means-testing of Social Security and Medicare; raising the retirement age and the years of contribution required for full benefits to accrue; eliminating the mortgage interest tax credit; introducing a value-added tax; raising the gasoline tax; and embarking on a major efficiency drive, including reductions in defense spending.

The president's bipartisan commission on budget deficit reduction has aired some of these thorny reform ideas, but politicians have been staying as far away from them as possible. Making progress toward them in the new Congress, which will be even more gridlocked than the last one, could prove very difficult.

Not only is further global rebalancing unlikely, it is not necessarily desirable.

However, if U.S. politicians were to move on some of these measures, and also were to recognize that the problems that the rebalancing agenda is designed to address are made in Washington—not in Berlin or Beijing—the likelihood of worse outcomes, notably in the form of escalating currency and trade disputes, would be reduced.

China also has much to do—though, in fairness, it has already contributed more to global rebalancing than has any other country. Its domestic demand has increased by 41 percent since 2006–2007 (while demand has hardly changed in the advanced countries); its current account surplus has declined by 5 percent of GDP; and its real exchange rate has appreciated by more than that of any other large country, compared to its ten-year pre-crisis average.

Nonetheless, China needs to remove artificial impediments to growth in its domestic consumption and spur the development of its backward regions. Chinese consumers are unnecessarily penalized by the very low dividend requirements placed on state companies and by artificially low interest rates for consumer deposits. China could also reduce savings by creating a better social safety net, financed by reductions in government surpluses. The easiest available step, gradually appreciating the RMB (aiming, say, for a 20 percent appreciation over three years), would—in combination with the measures mentioned above—boost consumer incomes and encourage spending while also partially dampening inflationary pressures.

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China cannot grow much faster—the country's output is already straining capacity, its inflation rate is edging upward, and its urban housing prices are soaring. But China can spend more on imported products. However, one should stress that these measures are important mainly for China's own sake: The additional contribution that China can make in 2011 to demand in the G20 countries would be small.

Japan has attempted every expedient in the macroeconomic policy book for reigniting domestic demand, with little success. The yen has seen a large appreciation since the onset of the crisis, but the solution to Japan's problems does not lie in a lower currency. Instead, Japan needs to break its political logjam so as to undertake far-reaching structural reforms, such as increasing competition in the services sector, and it also must allow more immigration to compensate for declines in its labor force. These long-term reforms would establish the conditions for Japan's domestic demand to start growing rapidly again, which would also aid the country's trading partners. As in China's case, these reforms are crucial for Japan itself.

In the euro zone, Germany and other core countries have seen strong export growth, but over the past decade, only very slow growth in domestic demand. Germany's size, along with its strong fiscal and external positions, singles it out as a country capable of supporting adjustments in the uncompetitive and debt-afflicted states on the European periphery. Germany could import more from them, as they no longer have the option to devalue their currencies. Failure by these nations to get their fiscal houses in order and regain economic competitiveness could sooner or later trigger a massive financial crisis in the heart of Europe and even risk the viability of the European project. For this reason, Germany's external surplus is uniquely worrisome—though, at 6 percent of GDP, it is high but not extraordinary.

BEYOND THE BIG FOUR

Meanwhile, emerging markets that are experiencing large inflows of foreign capital and appreciations in currency must decide how much of the inflow is justified by long-term fundamentals and how much is hot money responding to temporarily rock-bottom interest rates in advanced countries. In an environment of volatile and short-term inflows, it is justifiable to use currency interventions, accumulate reserves, and, as a last resort, levy taxes on capital inflows and impose other such controls. This means emerging markets' contribution to global demand growth will be limited by the amount they can borrow prudently, as well as by their capacity to grow without creating inflation and asset bubbles.

Finally, international organizations have an important role to play in supporting these adjustments. The focus of the G20 and the IMF, and of the finance ministries that set their agendas, should shift away from global rebalancing, which sounds and plays like a zero-sum game. Instead, the focus across economies should be on growth of domestic demand in individual countries, with an eye toward maintaining that growth at the fastest sustainable rate. The IMF can advise countries on this agenda through its Article IV surveillance capacity, the G20 Mutual Assessment Process, and various assistance programs.

No one solution will work for all countries: Some may still be able to push the demand accelerator, while others will have to press the brakes. It bears noting that no strict correlation exists between external deficit or surplus countries and those that can grow faster in 2011–2012. Some deficit countries (for example, the United States and the United Kingdom) could do more to stimulate domestic demand in the short term. Some surplus countries (for example, Japan) can do little more than they are already doing. Others (for example, China) are already growing at a breakneck pace and confronting inflationary pressures. For all of these reasons, discussions of currencies and external balances should be secondary to an agenda for sustainable growth.

AND IF NOTHING HAPPENS

If countries do not enact needed reforms, the most important adverse consequences will be domestic. In the United States, short-term growth will be slower in the absence of additional fiscal stimulus; without medium-term fiscal reforms, growth will become unbalanced again and the economy will be vulnerable to a sudden loss of market confidence. If China does not carry out reforms, it will remain overly reliant on export markets, and the sustainability of its development model will be in question. Japan, unless it undertakes far-reaching structural reforms, will fail to get out of its rut. And the euro zone, absent German leadership, may experience a series of sovereign debt crises, either leading the zone to break up or requiring its core countries to inject massive amounts of taxpayer money into the periphery. Germany would be among the biggest losers.

The international repercussions of a failure to deal with domestic challenges in the large economies will also be severe. One danger is that the United States and other advanced countries, having failed to enact appropriate fiscal measures and structural reforms, will rely too heavily on monetary policy to stimulate demand. For now, large gaps between actual output and its potential, as well as high inflation rates, suggest that interest rates in many advanced economies—particularly Japan, the United States, and Italy, and other debt-stricken countries within the euro zone—are actually too high. With policy rates close to zero, countries, including most prominently the United States, are turning to unconventional measures such as balance sheet expansion (quantitative easing) to increase liquidity and spur private demand.

But serious domestic and international risks are associated with quantitative easing. First, it is not clear that such a policy succeeds in affecting long-term interest rates, nor is it obvious that even lower interest rates could significantly stimulate demand. Even more worrisome is that quantitative easing could encourage risky investor behavior such as carry trades (borrowing at low interest rates to invest in higher-yielding instruments, often in a different currency). This in turn would raise questions about central banks' ability to withdraw large liquidity injections without wreaking havoc on exposed investors. Quantitative easing in the major advanced economies can also be read as an attempt to devalue their currencies, exacerbating currency tensions.

The risks surrounding quantitative easing in advanced economies are of special concern to emerging markets. Several are already dealing with symptoms of overheating, and others are at risk of the same.

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Brazil and Turkey have seen large, real exchange-rate appreciation relative to their ten-year pre-crisis averages, while current account deficits in other economies, such as India, have already deteriorated significantly from pre-crisis averages. Even with currencies appreciating in emerging markets, the increase in their domestic demand caused by large inflows of capital (implied by further quantitative easing in advanced countries) would inevitably spill over into their non-tradable goods and services, stoking inflation, real wage increases, and housing and asset price bubbles. This is a sure recipe for instability down the road, and could pave the way for the next big financial crisis, this time originating in emerging markets.

As dangerous as large domestic and cross-border flows of hot money are, an even greater threat looms. A resurgence of protectionism may be in the offing if countries fail to enact necessary domestic reforms and the global economic situation worsens. Countries that are unable to stem the revaluation of their currencies or that see current account deficits surge again could easily resort to trade restrictions. Thus, today's open disputes over current account targets and veiled threats of increased currency intervention could evolve into tomorrow's trade restrictions. Such an outcome would not only threaten the global recovery but would also undermine the foundations of postwar global prosperity.

The G20—beginning with the United States, the largest economy and owner of the global reserve currency—would be well advised to drop its dangerous obsession with rebalancing. Instead, countries should concentrate on fixing their domestic problems and expanding domestic demand at the maximum sustainable rate. ■

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1779 Massachusetts Avenue, NW
Washington, DC 20036

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