A Return of Global Imbalances

Joseph E. Gagnon discusses his research into the causes of massive current account surpluses and deficits and warns that these imbalances have begun to recur.

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Steve Weisman: A factor in the recent financial meltdown, many people say, was global imbalances—big current account surpluses and deficits of the major countries. Joseph Gagnon, senior fellow at the Peterson Institute for International Economics, is studying whether the world is headed back into another period of imbalances with the recovery struggling to get underway. Joe, thanks for joining me.

Joseph Gagnon: Thanks, Steve. Good to be here again.

Steve Weisman: First: What are global imbalances?

Joseph Gagnon: The global imbalances I'm talking about are the current account imbalances, effectively when countries as a whole borrow from and lend to each other. If you run a surplus, you're selling more goods and services to foreigners. Because of the way the economy works, you're lending to them. And if you have a deficit, then you're borrowing from them.

Steve Weisman: [Fed chairman] Ben Bernanke has called it the global savings glut. Is that an appropriate term?

Joseph Gagnon: I think so. I think it certainly was a catchy term. It's been misunderstood somewhat. But the point that he was getting at, I believe, is a correct one, which is that a number of countries in the world, especially in Asia, had decided that they wanted to send more of their savings into the rest of the world and have a current account surplus, and invest the money especially in the United States. And this actually drove down interest rates in the United States and was related to what Chairman Greenspan called the conundrum in the mid-2000s when bond yields were dropping even when the Fed was raising interest rates, trying to tighten monetary policy. At that point, the flood of capital was still pushing down rates around the world.

Steve Weisman: After the Great Recession accelerated in 2008, these imbalances were reduced. Why?

Joseph Gagnon: Basically, people stopped spending around the world. People were afraid. And that meant that the countries exporting more lost more customers than the countries importing more. In other words the United States, in a sense, benefited from that because when Americans stopped spending, a lot of that spending was on Chinese goods and other imported goods. So the Chinese lost their exports. We stopped importing. Our imbalance shrank. Their imbalance shrank because everyone stopped spending.

Steve Weisman: With the recovery picking up somewhat in the United States and India and China other countries in Asia roaring ahead, what's the picture on whether we're going to see these imbalances reemerge?

Joseph Gagnon: I think there are several elements, and they're actually tricky to disentangle. My best guess is that the imbalances are kind of back, though. One element that's going the other way towards shrinking the imbalance is that US consumers are saving more. By saving more, US consumers are not buying as many imports, and that helps to shrink the imbalance. And US businesses are also actually saving quite a bit lately.

But opposed to that, of course, is that the US government is borrowing like crazy. That's needed because, in fact, without that we'd be in a huge depression. So that's going the other way. And the interesting thing will be going forward over the next five years, which is what I recently had been looking at in a recent working paper here at the Peterson Institute. It looks to me that countries like the United States are still going to have fairly large budget deficits even several years down the road. If eventually consumers start spending and corporations start investing, and we don't get our budget deficit down, that will push our current account deficit back up quite a bit. That's one part of the picture.

The other part of the picture is what's going on in China and in developing countries. There, I think, there's also a tug-of-war. On the one hand, they are growing fast. They're taking steps to increase their consumption, which would help to shrink their imbalances. But at the same time, their governments are trying to hold down their currencies to keep their exports strong. And they're taking that money and investing it in the United States and other rich countries. And that was what they were doing in the mid-2000s, and they're going back to doing that again. I think if they keep that up, that's going to also cause the imbalances to return.

There are several factors in play and it's a question of which takes over. But I think already we're seeing some movement back towards wider imbalances. And the deficits in the rich countries and the currency manipulation in the emerging markets are getting ahead of the other factors.

Steve Weisman: I'm glad you mentioned the working paper. You brought a new methodology to examining this problem. Can you explain?

Joseph Gagnon: The working paper picks up on some work that's been out there in the economics literature and extends it a bit. This kind of literature looks at differences across countries and some of their economic fundamentals and how that relates to current account imbalances. We can explain a certain amount of the global imbalances by just four factors.

Steve Weisman: And they are?

Joseph Gagnon: They are the fiscal deficit that we talked about, the budget deficits that countries have. They are this accumulation of reserves and official assets that are the result of this tendency of emerging markets to try to hold their currencies down—currency manipulation in other words—to get exports, trying to measure that through how much they buy. That matters a lot for developing countries.

Also, how much countries own already in foreign countries matters because if you already own a big stock of assets, you tend to have earnings on that asset and those earnings are actually considered part of the current account. Finally, the price of oil or how much you export in oil, because oil exporters—particularly when oil prices go up—tend to get big boosts in their export dollars just from the price of oil. They don't spend that very quickly.

That tends to boost their current account. Those four factors explain between half and two-thirds of the current accounts around the world.

Steve Weisman: How much do countries like China have to buy in terms of dollars in order to keep the peg on their currency's relationship with the dollar?

Joseph Gagnon: Well, a lot. Up until now, it's been pretty close to one-for-one. Basically their buying of dollars, euros, and yen, but mostly dollars, has been pretty much equal to their current account surplus. That's actually not a coincidence, because China puts a lot of restrictions on other types of transactions. It's hard for us to invest in China. It's hard for Chinese to invest in the United States. Basically, the only way they can have a current account surplus is if their government invests that money abroad for them.

But they're starting to liberalize and there are starting to be some new channels for money to get into China and money to get out of China. Capital flow is starting to be important for them, and I think that will continue. If they want to keep their currency undervalued, they're going to increasingly have to buy more and more reserves. So now, the amount that they buy will start exceeding their current account surplus. They already have the largest reserves in history by some humongous multiple. How humongous can continue to be a big question.

Steve Weisman: So you discern that a trend is under way in which these surpluses for China are on the rise again.

Joseph Gagnon: Yes, they are. The Chinese haven't released their current account balance for 2010 yet, and I guess nobody has of yet. But we can look at their trade balance, which is the biggest part of it, and that is roughly unchanged between 2009 and 2010. But if you look underneath it, you find that's because their trade surplus collapsed in the first three or four months of 2010. And then it surged in the rest of the year. Even though their current account didn't grow last year probably, if you look within the year, there's a strong trend upward. If it just continues this year at the rate it was in the second half of last year, then it's going to be much higher this year.

Steve Weisman: But will it be as high as the peak of a few years ago?

Joseph Gagnon: No. I think it would take a while for them to get back to where they were, and ultimately it will all depend on what their policy is for their currency.

Steve Weisman: It doesn't sound like we're embarking on a new path, or that the meeting between President Obama and President Hu addressed the issue.

Joseph Gagnon: Yes, and more broadly the G-20. The G-20 has given a high priority to reducing current account imbalances or at the minimum preventing them from rewidening. But I think they're already behind the curve. You can already see in the United States, in China, in Japan, and in Germany, they're rising in the second half of last year. I see no reason why that won't continue. It's a question of how fast it will continue, but I don't see much doubt that it will continue to some extent unless policy is changed.

Steve Weisman: What do we say when the Chinese say to the United States, "Well you have to get your own [fiscal] house in order." You're not in favor of fiscal consolidation right away.

Joseph Gagnon: My response is in two parts. One is that as long as China insists that it has unilateral and total control over its exchange rate, regardless of the wishes of the United States—which seems unfair given that any exchange rate has as much to do with one country as the other country—why China should have complete control over that, I don't know. As long as they insist on that, then it's going to be their responsibility primarily to deal with the imbalance because they're the ones who are causing it.

But you're right that in the broader sense, beyond just US-China. China's only a part of the world, and we have a current kind of deficit with the whole world not just with China. And our budget deficit is clearly an important factor. But the way to think about that is: If our economy were running at full potential, if employment were at some normal level or even below, if we were exceeding, if we were overheating, then absolutely we should be cutting our budget deficit urgently. And we should be on a glide path as we see the economy get back to potential. We should be on a glide path to reduce the budget to zero [or] a small number. But we aren't there yet, and we are a long way from being there yet. So that's why.

China, on the other hand, is pretty much at full potential. They're having some inflationary problems. One can exaggerate how big their inflationary problem is, but no one doubts that they are running a much stronger economy than us, that they are closer to their potential. So therefore, they're the ones that are closer than us to the time at which they need to adjust. In fact, I would say they are at that time. They are tightening monetary policy in China. I think it will be better for them and for the whole world if they would tighten by letting their currency rise than by raising their interest rates, because one of those policies will hurt the rest of the world and one will help.

Steve Weisman: Which one is which?

Joseph Gagnon: I knew you were going to ask that. If they raise interest rates, that will cool off the Chinese economy, as they wish. So fine for them. But it will reduce Chinese demand for [goods from] the rest of the world, which is struggling—especially the United States, Japan, and Europe. On the other hand, if they let their currency appreciate, that will also cool off Chinese economy equally well for their own purposes, but it will increase Chinese demand for US, Japanese, and European products, which will help the rest of the world. So China can either help the rest of the world or can hurt the rest of the world. Either way, it'll be helping itself.

Steve Weisman: Joe Gagnon, thanks so much.

Joseph Gagnon: You're welcome.