Global Imbalances and the US Trade Deficit

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1. Introduction

Since long before the crisis of 2008-9, many observers have been concerned about the long-run sustainability of the US current account deficit and the corresponding surpluses in several of its trading partners, a situation that has come to be known as the problem of “global imbalances.” The large international trade imbalances of the past decade can be viewed in part as the result of different national solutions to the same underlying problem, as identified in the chapters by Palley and Setterfield in this volume: the fact that real wage growth was lagging behind productivity growth, thereby suppressing incomes of working-class and middle-class households and creating a latent deficiency of aggregate demand. The US solved this problem by relying on the housing price bubble and household debt accumulation to boost consumption in spite of stagnant earnings, while the surplus nations instead relied on export markets to augment weak domestic demand and lent the US the funds required to finance the resulting trade imbalances. Those US citizens who managed to keep their jobs and didn’t have to compete with imports were able to benefit from cheaper imported consumer goods, while US multinational corporations profited from outsourcing to lower-wage locations abroad, but these gains were obtained at the cost of chronically depressed manufacturing employment and wages at home.¹

The global trade imbalances were not a direct cause of the financial crisis and Great Recession of those years, although trade linkages were an important mechanism for transmitting the recession’s effects around the world. Moreover, this chapter will argue that the US trade deficit and foreign trade surpluses were at least a contributing factor (and in some respects a necessary enabling factor) in the run-up of the unsustainable financial positions in the US economy that led to the crisis and recession. The US deficit and foreign surpluses will not
disappear automatically during the post-crisis period, and the more rapid is the recovery, the more likely they are to increase again unless countermeasures to rebalance the global economy are adopted.

No single factor explains the US trade deficit or the global imbalances. As argued in Blecker (2009), the US has been caught in a “trade deficit trap,” in which the trade deficit is sustained by a web of interconnected and self-reinforcing mechanisms both at home and abroad that make it very difficult to reduce it through conventional policies. The trade deficit trap argument encapsulates a number of factors that have been argued by some to be “the” main cause of the US trade deficit, and shows how these factors—far from being mutually exclusive causes—have rather interacted in mutually reinforcing ways to maintain a large trade deficit (except during the worst of the recession in 2008-9).2

The US trade deficit originated in the 1970s and 1980s through a loss of competitiveness of US industries relative to their foreign rivals combined with periodic bouts of dollar overvaluation (Blecker, 1996). Over time, so many industries moved offshore or began to outsource their inputs that, even when the dollar later depreciated, many products continued to be imported and prior levels of domestic production were never restored. This is an example of what economists call “hysteresis,” or long-lasting effects of a temporary cause (Baldwin, 1988).

At the same time, a complex set of financial linkages developed that sustained and further widened the trade deficit. A trade deficit must always be financed by a net sale of assets to (or net borrowing from) other countries, and other countries were eager to lend to the US due to their own excess of saving and suppression of domestic consumption as well as their desire to sustain domestic employment. By lending the US the money required to pay for the excess of US imports over US exports, the surplus countries effectively transferred manufacturing
employment from the US to themselves. In the meantime, the huge influx of foreign saving allowed American households and businesses to finance expenditures beyond what US national income and domestic saving would otherwise have permitted. One factor depressing the US household saving rate was the slow growth of middle-class incomes that was due, in part, to the disappearance of good-paying industrial jobs in industries battered by imports (see the chapter by Palley in this volume). In this respect, the trade deficit helped drive the US saving rate down, rather than the low saving rate “causing” the trade deficit.

In some periods (for example, 1997-2002), large financial inflows into the US helped to boost the value of the dollar, thereby disadvantaging US producers. However, even when the dollar fell (for example, from 2002 to early 2008), although US exports did increase significantly, so many US industries had moved offshore that it was difficult to replace many imported goods with domestic ones. Meanwhile, the private lending that had sustained the trade deficit was replaced by official lending (foreign central banks buying dollar assets) that had the same effect. The official intervention was largely concentrated in China and certain other East Asian countries, with the effect that their currencies did not appreciate as much as the major currencies (especially the euro, UK pound, and Canadian dollar) did after 2002. This growing discrepancy in the value of the dollar vis-à-vis different currencies became another obstacle to trade deficit adjustment, since the value of the dollar relative to the major currencies gave a misleading impression of how much it depreciated relative to the currencies of the developing countries that supplied a majority of US imports. We will return to the role of exchange rates and international financial flows below, but first we present a global perspective on the US trade deficit followed by an account of its recent behavior.
2. A global perspective

The term “global imbalances” is really a misnomer, because only a handful of nations account for the lion’s share of the world’s current account surpluses and the US is the only country with a truly large deficit. Figure 1 shows all the nations that had current account imbalances in excess of (positive or negative) $25 billion at the peak of the last global expansion in 2007. These data clearly reveal the skewed nature of the world’s trade imbalances. No other nation came close to the US deficit of $718 billion in that year. The three countries with the largest surpluses (all over $200 billion) were China, Germany, and Japan. After them, the countries with next two biggest surpluses were major exporters of natural resources, Saudi Arabia and Russia. Many of the world’s largest economies, such as those of Brazil, Canada, and India, do not have imbalances that reach the $25 billion threshold for inclusion in Figure 1.

Figure 1
Countries with current account imbalances in excess of $25 billion, 2007

Source: International Monetary Fund (IMF, 2010b).
Several conclusions emerge immediately from the data in Figure 1. First, there really isn’t a global problem of current account imbalances—rather, there is a very large US deficit that is primarily matched by surpluses in just three countries. Second, one cannot generalize about current account surpluses or deficits for broad groups of countries such as the industrialized, developing, and emerging market nations. Third, two regional neighbors that have large bilateral trade surpluses with the US—Canada and Mexico—do not have large multilateral imbalances (and do not appear in Figure 1) because their surpluses with the US are offset by deficits with the rest of the world. Fourth, although some individual countries in the European Union (EU) have had relatively large surpluses or deficits, these have mostly offset each other and the EU overall has generally had a moderate current account deficit in recent years (except for a big spike in 2008). Overall, the so-called global imbalances are primarily a US-East Asian phenomenon, with secondary imbalances of smaller magnitudes both within the EU and between the EU and the major resource-exporting nations.

3. Trends and cycles in the US trade deficit

Returning to the US trade deficit, Figure 2 shows two alternative measures: the current account balance and net exports of goods and services, both measured as percentages of gross domestic product (GDP). These two measures have generally been fairly close in magnitude, and for the rest of this chapter we will use the terms “current account” and “trade balance” interchangeably except where the distinction is important. By either measure, the trade deficit trended steadily downward during the fifteen-year period between 1992 and 2007, with only a brief and small pause during the recession of 2001. The trade deficit worsened notably in 2003-6,
when consumer spending boomed as a result of the housing price bubble and household debt accumulation. The current account deficit peaked at $803 billion, or about 6% of GDP, in 2006. The collapse of domestic consumer and investment demand during the 2008-9 recession reduced the current account deficit substantially, cutting it to $378 billion or 2.7% of GDP in 2009. But even the tepid recovery of late 2009 and 2010 led to a strong rebound in the current account deficit, which was expected to reach about $500 billion (about 4% of GDP) in 2010 in spite of sluggish GDP growth and unemployment that was still hovering around 9.5%.

Figure 2
U.S. current account balance and net exports of goods and services as percentages of GDP, 1973Q1 to 2010Q3

Source: US Bureau of Economic Analysis (BEA, 2010c) and author’s calculations. Net exports of goods and services and GDP are from Tables 1.1.5 and the current account balance is measured by “net lending” in Table 5.1. Data for 2010Q3 are advance estimates and are not available for the current account.

The changes in the trade deficit diminished the magnitude of the changes in US output and employment during the recession and recovery (both on the downside and in the upswing), while transmitting these shocks to other countries. For example, between 2008Q2 and 2009Q2, real GDP fell by 4.1% but real imports of goods fell by 21.1%, while between 2009Q3 and 2010Q3 GDP increased by 3.1% but goods imports rose by 18.5% (US BEA, 2010a, Table 8).
Thus, some of the job losses during the recession were felt in countries that export to the US, but by the same logic a large portion of rising demand during the recovery was siphoned off to purchase imports and did not contribute to output or job growth in the US economy.\(^6\) Although it may be hard to believe, the recession of 2008-9 would have been even worse in the US in the absence of the fall in the trade deficit, but the impact was correspondingly more severe in US trading partners such as neighboring Mexico. By the same token, the rising trade deficit was a major reason why the recovery in US output and employment was so sluggish in 2009-10.

Taking a longer historical view, it is clear that—in spite of these large cyclical swings—the US trade balance has trended downward (as a percentage of GDP) during the entire period since the abandonment of the Bretton Woods system of fixed exchange rates and capital controls in 1973. Contrary to what was predicted by the advocates of flexible exchange rates and financial market deregulation (e.g., Friedman, 1953), floating rates and financial liberalization have led to greater, not smaller, global trade imbalances (see Eatwell and Taylor, 2000; Kregel, 2008). The next sections focus on the reasons for this long-term worsening trend.

4. The role of the dollar’s exchange rate

During the first two decades after the dollar began to float in value in 1973, there was a positive correlation between the value of the US dollar and the trade deficit. Figure 3 shows this by plotting the real trade \textit{deficit} (i.e., net exports of goods and services with the sign reversed, so that a positive number indicates a deficit, measured as a percentage of real GDP, with both net exports and GDP expressed in chained 2005 prices) versus the Federal Reserve’s broad index of the real (inflation-adjusted) value of the dollar.\(^7\) Although the correlation is far from perfect—
since other factors also affect the trade deficit, as discussed below—it is clear that, until the late 1990s, increases in the dollar’s value normally led to increases in the trade deficit and conversely, with time lags that averaged about 1-2 years. The lags are explained by the time it takes to order, produce, and ship goods in response to changed international prices. The period from 2002 to 2007 was unusual, however, because the trade deficit did not begin to decline until 2007, five years after the dollar began to fall.

**Figure 3**
The real value of the dollar and the real trade deficit, quarterly, 1973Q1 to 2010Q3

Source: US BEA (2010c), Tables 1.1.5 and 5.1; US Federal Reserve Board (2010b); and author’s calculations. The real trade deficit is measured by net exports of goods and services at chained 2005 prices.

An important reason for the disappointing trade benefits from the falling value of the dollar in this period was the uneven degree to which the dollar fell relative to different currencies at that time. Figure 4 again shows the Federal Reserve’s broad index of the real value of the dollar as the solid line (this is the same dollar index shown in Figure 3). The broad index declined by 25.4% between its peak in February 2002 and its trough in April 2008. However, this decline masks important differences between the dollar’s performance in relation to different
groups of currencies. During the same period, the dollar fell 32.5% relative to the “major”
currencies (the euro, Canadian dollar, Japanese yen, UK pound, Swiss franc, Australian dollar,
and Swedish krona, shown by the dotted line in Figure 4), but only 15.6% relative to the
currencies of “other important trading partners,” i.e., the developing countries and transition
economies, many of which have fixed or managed exchange rates (shown by the dashed lined in
Figure 4). Yet, the “other” countries (which include major exporters such as China and Mexico)
account for more than half of total US imports and two-thirds of the trade deficit.9 It is very
difficult for an exchange rate adjustment to eliminate a large trade deficit when most of the
imports are coming from precisely those countries whose currencies are not adjusting as much.

Figure 4
Indexes of the real value of the US dollar, monthly, January 1973 to September 2010

Nevertheless, the drop in the dollar vis-à-vis the currencies of the major industrialized
countries from 2002 to early 2008 did some good at the time. Since US exports of manufactures
compete in global markets mainly with the products of other industrialized nations, the lower
dollar relative to the euro, pound, and Canadian dollar (and, to a lesser extent, the Japanese yen) helped to stimulate strong growth of US exports from 2003 to 2008. Especially in 2007 and early 2008, as the housing sector collapsed and the economy was falling into a recession, exports were one of the few bright spots. This strong export growth was reversed between late 2008 and 2010, however, as the global recession and sluggish recovery sharply cut demand for US exports abroad.

At the end of 2008, the dollar recovered rapidly but only partially as a perverse result of the financial crisis. Even though the crisis broke out in US financial markets for securitized mortgages and derivative instruments, the global loss of confidence led to a “flight to safety” in what was still perceived as the world’s safest asset, US treasury bills, thus increasing the demand for dollars. A similar phenomenon occurred in mid-2010, when panic over the Greek financial crisis led currency speculators to temporarily dump euros and seek “safe haven” in the dollar and other strong currencies. In spite of these upward blips in the dollar, as of late 2010 it remained at a relatively low real value, similar to where it had been at the end of 2007, but it had not fallen below that level. As three prominent economists have observed, “So long as the dollar exchange rate continues to be driven more by capital flows than by the correlates of the current account, and so long as the U.S. treasury market continues to be seen as a safe haven, it is hard to see how [...] the halving of the U.S. current account deficit [via dollar depreciation] can be sustained.” (Chinn et al., 2010, p. 4).

5. The trade and budget deficits are not twins

Since dollar depreciation has not sufficed to reduce the trade deficit, some economists
and policy analysts have sought to revive the twin deficits hypothesis that was popular in the 1980s (for retrospectives, see Feldstein, 1992; Blecker, 1996). This hypothesis blames the trade deficit on the government budget deficit, and claims that the only way to reduce the former is by lowering the latter. The primary motivation behind the twin deficits argument is to absolve international trade policies and industrial competitiveness factors from any responsibility for the burgeoning US external deficit, so as to weaken the case for “protectionist” responses. The fault, it is claimed, lies strictly in ourselves, in that we (the American public) have been unwilling to make the “hard choices” (tax increases or spending cuts) required to reduce the budget deficit.

The raw data do not reveal much support for the twin deficit hypothesis. Figure 5 shows the two deficits, both measured as percentages of GDP, using quarterly data from 1973Q1 to 2010Q2. During most of the period shown, the two deficits generally moved in opposite directions, exactly the reverse of what the twin deficit hypothesis implies. For example, when the fiscal balance increased from a deficit of \(-6\%\) of GDP in 1992 to a surplus of \(+2\%\) in 2000, the current account balance did not improve, but rather worsened from about \(-1\%\) of GDP to \(-4\%\) during the same period. This pattern largely reflects the natural operation of the business cycle: the strong economic expansion of the late 1990s increased government tax revenue, thereby reducing the budget deficit, while also increasing import demand, thus worsening the trade deficit. The fiscal improvement of the 1990s was also aided by Bill Clinton’s tax increases of 1993 and budgetary rules that limited spending growth, but these fiscal belt-tightening measures failed to prevent the current account from worsening instead of improving.

An even more dramatic divergence between the two deficits opened up in 2008-9, when the budget deficit grew dramatically during the Great Recession to about \(-12\%\) of GDP, but the current account deficit (as noted earlier) diminished to only about \(-3\%\) of GDP. This opposite
behavior of the two deficits was largely due to the effects of the recession, which reduced tax revenue for the government (thus increasing its deficit) but also reduced import demand (thus moderating the current account deficit).

**Figure 5**

US current account, government budget, and private saving-investment balances as percentages of GDP, 1973Q1 to 2010Q2

Source: US BEA (2010c) and author’s calculations. GDP is from Tables 1.1.5, the current account balance is measured by “net lending” from Table 5.1, and the government budget balance (federal, state, and local combined) is measured by “government net lending” in Table 3.1.

There were two exceptional periods when large tax cuts and increased military spending under presidents Ronald Reagan and George W. Bush helped to spark higher trade deficits in 1981-83 and 2001-3, respectively. In the more recent of these periods, the budget reversed gears and plummeted from the +2% of GDP surplus recorded in 2000 to a −5% of GDP deficit in 2003, and during this brief period the two deficits did move in the same direction. However, this temporary coincidence hardly proves the twin deficit view. After all, the trade deficit was merely continuing its long-term downward trend, and if anything its rate of deterioration slowed down during 2001-3 while the budget balance was dropping rapidly.\(^\text{10}\)
Statistical studies of the relationship between the fiscal (budget) and trade (current account) balances have yielded mixed results. Blecker (2009) estimates a vector error correction model using US quarterly data for 1973Q1 to 2008Q3, in which the impulse responses show no significant effects of innovations in (i.e., exogenous shocks to) the budget balance on the trade balance, after controlling for the dollar’s exchange rate and the private saving-investment balance (discussed in the next subsection). Other studies have found modest positive effects of the budget balance on the trade balance. For example, Bernanke (2005) cited a study by Erceg et al. (2005), who estimated that for every dollar of budget deficit reduction the current account deficit falls by less than 20 cents.

Some studies using international panel data find positive effects of budget balances on current account balances after controlling for other variables. For example, in a multivariate model for explaining the current account balance using data up to 2004, Chinn and Ito (2007) obtain a point estimate of 0.15 for the coefficient on the government budget balance for their full sample of countries (0.16 for the industrial countries), implying that for every one percentage point increase in the fiscal balance, the current account balance rises by 0.15 (0.16) percentage points; sensitivity tests yield a wide range of about 0.1 to 0.5 for this coefficient in a variety of specifications. Using more recent data (through 2008) but a similar econometric specification, Chinn et al. (2010) find a coefficient on the government budget balance of 0.283 for their full sample of countries and 0.414 for the industrialized countries in their baseline regressions; these coefficients change to 0.295 and 0.289, respectively, when additional institutional variables are included.

However, one must be very cautious in applying results from international panel regressions to any particular country, especially one as exceptional as the US. Indeed, the US is
an outlier in the regression models of Chinn and Ito (2007, 2008), as its current account balance is generally below a 95% confidence interval around the model’s fitted values for the periods 1996-2000 and 2001-4; also their models underpredict the US current account deficit in out-of-sample forecasts. Chinn et al. (2010) find that a dummy for the US in the 2001-5 subperiod is significantly negative, suggesting that their model does not fully explain the decline in the US current account balance at that time.

Overall, these econometric estimates suggest that the relationship between the budget and trade deficits is at most partial, and if anything is probably weaker in the US than in most other countries. Interestingly, the highest coefficients are obtained in models that control for numerous other variables, suggesting the importance of many other causes of the current account besides fiscal policy even when the effects of the latter are found to be statistically significant. These studies explain why a positive correlation between the two deficits is observed in the US data only at times of relatively large fiscal shocks, such as 1981-83 and 2001-3.

6. Saving, investment, and the current account

Economists who support the twin deficit view have rested their case on the famous “national income identity,” which is an accounting relationship between the two deficits and the gap between domestic (private) saving and investment. This identity can be written as follows:

\[
\text{Current account balance} = (\text{Saving} - \text{Investment}) + \text{Government budget balance}
\]

This accounting identity is very important: it implies that changes in any one of the three
balances (fiscal, trade, and private saving-investment) must be accompanied by offsetting changes in the other two combined. However, there are two problems with the way in which this identity is often employed. First, an accounting identity is not a causal relationship: there is no implication that causality has to flow in any particular direction between the variables linked by it. Rather than the fiscal balance always driving the trade balance, any other direction of causality among the three balances is also possible, and it is also possible (indeed, likely) that common underlying factors (such as the business cycle) may account for coincident movements in all of these variables that together keep the identity holding. Second, the identity includes the private saving-investment balance as well as the current account and government budget balances, so there is no automatic link between the latter two.

Although the fiscal balance seems to have played little role in the widening of the trade imbalance in the late 1990s and the 2003-7 period, there is more evidence that changes in the private saving-investment balance played a significant role in these episodes, at least in an accounting sense. As Figure 5 shows, the saving-investment balance was normally positive in the US economy until the late 1990s. This meant that private, domestic saving was generally more than sufficient to finance private, domestic investment—and the private sector usually had excess funds to lend out, either to the government (if it had a budget deficit) or to foreign countries (when the US had a current account surplus). The saving-investment balance behaved countercyclically, that is, it rose in recessions and fell in recoveries, because investment is more cyclically sensitive than saving.

However, the private saving-investment balance exhibited an unprecedented drop into negative territory during the 1996-2000 period, and, after rising in the recession of 2000-1, fell back to negative levels in the subsequent recovery (especially 2004-7). During the times when
the saving-investment gap was negative, the US private sector was unable to finance domestic investment spending. The negative saving-investment gap had to be filled by some combination of either an increased budget surplus (which means more government net lending to the private sector) or a reduced current account balance (which implies increased borrowing from abroad).

At least in an accounting sense, then, the fall in private saving relative to investment “explains” how the trade deficit could continue to worsen in the late 1990s in spite of the big improvement in the fiscal balance. Also, the budget deficit was decreasing in the years 2003-7 while the trade deficit was widening rapidly; it was again the fall in the saving-investment balance that was correlated with the worsening of the current account at that time.

During the crisis of 2008-9, the saving-investment balance recovered to the highest levels since the recession of 1975 (about +7% of GDP) as households were striving to restore their balance sheets and both consumption and investment spending plummeted (see Figure 5). This sharp rise in the saving-investment balance was virtually the mirror image of the sharp decline in the budget balance in those same years, and the swings in these two balances utterly swamped the relatively small increase in the current account balance. Taking the previous cycle peak year of 2007 as a base, the saving-investment balance rose by about 8 percentage points of GDP over the next two years, while the government budget balance fell by about 10 percentage points of GDP; in contrast, the current account improved by only about 2 percentage points of GDP.

Prior to the crisis, what is most striking is that the current account trended downward steadily for more than a decade (from 1993-2007) in spite of large fluctuations in the other two balances that largely offset each other (see Figure 5). This suggests that changes in the other two balances were mostly impacting each other, not the current account balance—an inference that is supported by the impulse responses from Blecker’s (2009) VEC model. Furthermore, the steady
trend in the current account suggests that this was likely to have been caused by some independent factors that were driving it downward, and that the sum of the two domestic balances was being pulled along with it endogenously (even while the division of that sum among the other two balances kept shifting).

Nevertheless, some have argued that the drop in the private saving rate during the 1997-2007 period could be an independent causal factor in explaining the rise in the current account deficit (see Chinn, 2010). While corporate savings held steady during that period, the personal saving rate declined for reasons that are explained elsewhere in this volume (see the chapters by Setterfield, Palley, and Cynamon and Fazzari). As median wages and household incomes stagnated in spite of rising productivity, households increasingly relied on debt to finance consumption expenditures, and this was aided by the boom in housing prices as well as innovative lending practices by creditors. Thus, even if government profligacy is not to blame for the trade deficit, perhaps the consumption spending binge of the pre-crisis decade, which pulled the personal saving rate down to historic lows, is a culprit?

One problem with this argument is the issue of “reverse causality”: by contributing to the suppression of median wages and middle-class incomes, the trade deficit was at least partly a cause of the low saving rate rather than an effect. Also, what matters in the national income identity is the difference between saving and investment, not saving per se. Thus, the decline in saving alone cannot explain the rise in the trade deficit; rather, the interesting question is why private investment was able to remain relatively robust in the late 1990s and early 2000s (i.e., before the housing bubble burst in 2007-8) in spite of the decrease in private saving. To understand how this was possible, we need to examine the role of the net financial inflows from abroad that are the proverbial “other side of the coin” of the current account deficit—and which
were one of the independent factors driving that deficit to new heights.

6.1 Net financial inflows and the “global saving glut”

When the private saving-investment balance turned negative in the late 1990s and again in the early 2000s, the openness of the US economy to international financial flows meant that the extra saving needed to finance domestic investment (including housing construction) could be borrowed from other countries. This international borrowing was a necessary enabling factor for the decline in the private saving-investment balance to occur. Without the increase in the current account deficit and the corresponding net inflow of foreign funds, it would have been impossible for the saving-investment balance to fall as far as it did up to 2006-7. To be clear, the argument is not that, in the absence of the increasing trade deficit, the fall in the saving rate would have raised interest rates and “crowded out” investment. Rather, the argument is that, in the absence of the trade deficit and the associated financial inflows, the saving rate could never have fallen so much to begin with.

What factors drew so much foreign capital into US financial markets beginning in the mid-1990s? One factor was increases in US interest rates instigated by the Federal Reserve in 1994-95, 2000, and 2004-6, when it was launching pre-emptive strikes against possible higher inflation during periods of economic recovery or boom. Another factor that became important in the late 1990s was the “IT” bubble in the US stock market, which attracted foreign inflows of funds, and another stock price bubble that popped up in the mid-2000s. Yet another factor was the financial crises of the late 1990s in Asia and other developing regions, which induced risk-averse investors to park their funds in the safe haven of US assets. Also, as we will discuss in
more depth in the next section, an increasing portion of the net purchases of US assets after the
dollar began to fall in 2002 were “official” purchases by foreign central banks attempting to
resist market pressures toward appreciation of their countries’ currencies.

One controversial explanation for the rise in US net financial inflows is the hypothesis of
Bernanke argues that the US current account deficit has to be explained by policies and events in
the surplus countries as well as in the US, and that any explanation that rests solely upon US
domestic causes will miss the mark. He notes that the emerging market nations (including but not
limited to China) developed a significant excess of domestic saving in the late 1990s and early
2000s that ended up being invested in financial markets in the US rather than in productive
domestic investment in those nations. He is skeptical of orthodox economic explanations of those
increased saving rates, such as a life-cycle view, because demographic factors (i.e., aging of the
population) cannot account for the timing and location of when and where the excess saving
originated.

Bernanke’s core argument is sound, especially if the “saving glut” is interpreted in
Keynesian fashion as meaning “deficient demand”\textsuperscript{13} in the surplus countries. The real issue is
why consumption and investment are too low in those emerging market countries that have
become major exporters of excess saving. Consumption is repressed in these countries due to
wages lagging behind productivity, a phenomenon also found in the US as discussed in the
chapters by Palley and Setterfield. Instead of encouraging households to borrow to finance
additional consumption as the US did, these countries have instead relied upon export markets to
fill the resulting demand gap and maintain high employment. Their low wages (relative to
productivity) and, in many cases, undervalued currencies (discussed more in the next section)
contribute to their export surpluses, while their excess savings are invested in financial assets overseas (especially in the US) thereby financing the resulting trade imbalances (and keeping the dollar overvalued). Bernanke argues that the outflow of excess saving from the emerging market nations contributed to the high value of the US dollar and to the bubbles in US stock prices and housing prices that occurred at various times in the late 1990s and early 2000s. To the extent that these factors in turn boosted US consumer spending, the inflow of excess saving from abroad was a contributing factor in causing the low saving rates of US households during those years, and hence the low saving rates were not an independent cause of the current account deficit. This arrangement also implies that the world was relying on US consumer borrowing and asset price bubbles to sustain global demand, and these were not sustainable as the recent crisis has painfully illustrated.

There are also some more dubious aspects or extensions of the global saving glut argument. Some have claimed that the global saving glut helps to explain low long-term interest rates in the early 2000s, based on the classical “loanable funds” doctrine of interest rate determination. However, it is more credible to believe that short-term interest rates are determined by the monetary policies of central banks, while longer-term rates depend on both current short-term rates and expectations of future monetary policies and inflation. In any event, if the excess saving of the surplus countries are offsetting the reduced saving of the deficit countries, as implied in the core argument that the saving glut explains global trade imbalances, it is hard to see how the global “supply of saving” is really higher as a result.

Bernanke (2005) also suggested that “the attractiveness of the US as an investment destination” and “sophistication of the country’s financial markets” as factors pulling foreign savings into US financial markets, while Bernanke (2007) argued that “an underdeveloped
financial sector” within the emerging market nations led to their savings being invested abroad rather than domestically. These claims have given rise to the hypothesis that “capital market imperfections” in the emerging market nations make it difficult to channel saving into investment in those countries, so that rising domestic savings result in current account surpluses rather than increased domestic investment (see Caballero et al., 2008). Empirical tests by Chinn and Ito (2008) fail to find evidence that indicators of financial market development and the strength of financial institutions are inversely related to saving rates in emerging market nations. Chinn et al. (2010) find some evidence that the interaction of capital account openness and financial market development has a negative effect on current account balances across countries, but they do not show that this is a quantitatively significant factor in explaining the US deficit. Indeed, it is doubtful that it could be, because most of the net financial inflows into the US since the early 2000s have been the result of reserve accumulation by foreign monetary authorities rather than the operation of private capital markets.

7. Policy interventions and structural factors

The cumulative effect of the all borrowing to cover the trade deficits of the last generation has been to transform the US from the world’s largest creditor into the world’s largest debtor. While the US switched from an overall net creditor position to net debtor status in 1986, the net debt really ballooned after 2000 when it passed the $1 trillion threshold and rapidly climbed to $3.5 trillion at the end of 2008 before dipping slightly in 2009 (see Figure 6). Although the US status as a net debtor has been much commented on, the degree to which it reflects the impact of foreign governments’ official intervention in global currency markets has
not received the same attention.\textsuperscript{15}

Figure 6

\textbf{US net international investment position and foreign official assets in the US, yearend 1976 to 2009}


Figure 6 shows that foreign \textit{official} assets in the US—essentially, US currency, treasury bills, and other government-issued securities held by foreign central banks—more than account for the total net international debt in every year since 2005. In fact, by the end of 2009, foreign official assets in the US of $4.4 trillion were 60\% higher than the overall US net debtor position of $2.7 trillion. In other words, \textit{excluding this enormous debt to foreign central banks, the US was still a net creditor country} to the tune of about $1.7 trillion in all of its other (unofficial, i.e., non-central bank) international financial activities as of yearend 2009.

Thus, the growing foreign accumulation of US assets after 2000 was not primarily the result of increased confidence in the US economy or US assets by private-sector agents abroad, as contemplated in the models of “capital market imperfections.” On the contrary, it was mainly foreign central bank intervention that financed the growing US current account deficits and
allowed the US to build up this enormous foreign debt. The countries whose central banks have bought large volumes of US government assets as foreign exchange reserves have done so for two main reasons. First, these countries learned the lesson from the emerging market financial crises of 1997-99 in East Asia, Russia, and Brazil that having large volumes of reserves is essential to be able to defend their currencies from speculative attacks. Second, many of these same countries have deliberately sought to prevent their currencies from appreciating as much as they would have if they were allowed to float more freely.

The leading offender in this respect is China, with which (not coincidentally) the US has its largest bilateral trade deficit. China did allow its currency to appreciate very slowly between 2005 and 2008, and again starting in mid-2010.16 Notwithstanding this limited appreciation, China increased its foreign exchange reserves more than fourteen times, from $166 billion at the end of 2000 to $2.4 trillion at the end of 2009 (International Monetary Fund, 2010a). Assuming (as seems likely) that the vast majority of these reserves are held in US dollar assets, China’s reserves alone account probably account for about half of the $4.4 trillion in total foreign official assets in the US as of yearend 2009. Cline and Williamson (2009) estimate that the yuan would have to rise another 40% relative to the dollar to reduce China’s current account surplus from 10% of its GDP in 2009 to a more sustainable 4%. The persistent undervaluation of the yuan helps explain not only why China is the country with which the US has the largest bilateral deficit, but also why the US deficit with China is so disproportional. In recent years, US imports from China have averaged more than four times US exports to China, a ratio far greater than with any other major trading partner (US BEA, 2010d, Table 2a).17

In addition to these currency market interventions, changes in global trade patterns and US trade policies can have an independent impact on the trade balance. One factor that has
played into rising trade deficits is the uneven impact of recent trade agreements, including the North American Free Trade Agreement (NAFTA) of 1994, the World Trade Organization (WTO) that began in 1995, and—perhaps most significantly—the extension of “permanent normal trade relations” (formerly known as most-favored nation status) to China and China joining the WTO in 2001. While ostensibly these trade agreements have reciprocally opened markets both in the US and abroad—and foreign tariff reductions have often exceeded those of the US—the actual impact has been a disproportionate opening of the US market to imports from other countries. The main reason for this outcome is that these so-called “trade agreements” also include “deep integration” provisions protecting the rights of foreign investors and extending trade liberalization into services, and these provisions have largely operated to make other countries more attractive locations for US-based companies. Combined with the undervaluation of currencies and the suppression of wages and consumer demand in the surplus countries, the foreign market-opening provisions of the trade agreements have thus taken a back seat to their impact in encouraging outsourcing by US companies.

Finally, it is important to note that the hollowing-out of the US industrial structure in the past few decades has had a lasting impact in making it more difficult for the US to replace imports with domestic products when the dollar depreciates. Blecker (2007) estimates that the rise in the value of the dollar after 1995 had the cumulative effect of reducing the capital stock of the US manufacturing sector by 17% by yearend 2004, compared with what it would have been if the dollar had remained at its 1995 level. His estimates also show that annual investment in manufacturing was 61% lower in 2004 than it would have been if the dollar had remained at its 1995 value. Not only were significant portions of manufacturing capacity “offshored,” but also the remaining manufacturing industries have become increasingly dependent on imports of
intermediate goods (parts and components) that are no longer made at home. As a result, the dollar has to go much lower and stay down much longer to make it profitable for corporations to revive their production of tradable goods in the US.

8. Conclusions: what kind of global rebalancing?

This chapter has shown that the US trade deficit has been sustained by a set of self-reinforcing, mutually supportive mechanisms that are difficult to break out of, although they may be temporarily suspended during a severe economic downturn. No single policy lever that the US can pull will quickly or painlessly alter the US’s position as the main deficit country in the global pattern of trade imbalances. Traditional remedies, such as reducing the budget deficit or depreciating the dollar, will not be sufficient, although the latter is likely to be much more helpful than the former. Moreover, the US trade deficit results not only from US actions and policies, but also from events and policies in other countries—especially the excessive saving rates and currency market interventions of the major surplus nations in East Asia. For the US to be weaned off of its reliance on imports of cheap consumer goods and outsourced intermediate goods and its dependency on external borrowing, the rest of the world needs to be weaned off of its reliance on US markets for export demand and US assets as repositories for national saving.

This brings us to the frequently discussed idea of the need for “global rebalancing.” As usually proposed, rebalancing involves increasing private savings and reducing budget deficits in the US and other deficit countries, while increasing consumption and investment spending or engaging in fiscal expansion in the surplus countries. Often, rebalancing is thought to require a realignment of exchange rates in which the dollar falls further or stays low, and the currencies of
the surplus countries appreciate.

However, all the major surplus countries have significant structural or ideological impediments to the kind of adjustments that would be required of them (see Kregel, 2008; Chinn et al., 2010). Japan has had slow growth for two decades in spite of chronically low interest rates and repeated fiscal stimuli that have led to a large government debt; no one has yet solved the puzzle of how to boost domestic consumption and investment in Japan and replace its reliance on export demand. Germany has a deeply rooted aversion to fiscal deficits, and the European Central Bank is mandated by the Maastricht Agreement to uphold the German view that monetary policy should focus strictly on price stability and not output or employment targets. Even if Germany were to find a way to stimulate its economy, this would mainly benefit the deficit countries on the European periphery (UK, Ireland, Portugal, Spain, Italy, Greece, and eastern European nations) rather than the US.

China presents an interesting paradox. On the one hand, China currently depends on its undervalued currency and export surplus to maintain industrial employment and social peace. Chinese leaders seem aware that they need to bolster the internal market and not rely so much on the US export market in the long term, but they seem fearful of taking dramatic steps in this direction in the short term (and they don’t respond well to outside pressure). On the other hand, Chinese workers are becoming more restive and in recent years have won significant wage increases, which so far the government has not stepped in to prevent. Rising wages in China will have the same effect on its external competitiveness as a currency revaluation, with the added benefit of boosting Chinese workers’ consumption. China also adopted the largest fiscal stimulus in the world, estimated at 12.3% of its GDP, during the 2008-9 crisis (Kohli, 2010). While China did this for its own self-interest, its action helped to prevent a worse collapse in East Asia and
made a much greater contribution to promoting global recovery than that of any other nation (including the US, where Obama’s modest stimulus at the federal level was largely offset by budget cutbacks at the state and local levels). Thus, while China may not want to be pressured into agreeing to revalue its currency today, it may be effectively more willing to contribute to rebalancing efforts over the long haul than some other surplus countries provided that it sees its own self-interest in doing so. At least, China seems to be preparing for a world in which the US can no longer provide the demand-side engine of growth.

On the US side, it should be clear from the analysis in this chapter that a reduction in the fiscal deficit would do little if anything to lower the trade deficit. A strategy of budget deficit reduction would be especially inappropriate at a time when the economy still has high unemployment and underutilized resources, and in which private demand is likely to remain depressed due to collapsed housing prices and high debt burdens. In the long run, the federal budget deficit will not decline significantly unless and until the economy recovers and tax revenue naturally picks up, so makes more sense to focus on stimulating the economy than to target deficit reduction via tax increases or spending cuts (see also the chapters on fiscal policy by Baker and by Cynamon and Fazzari in this volume). As for inducing US households to save more and spend less, this has occurred spontaneously through the collapse of asset values and the tightening of credit availability since the financial crisis, but the result has been to depress aggregate demand and slow the recovery. What does make sense, as emphasized in the chapters by Setterfield and Palley, is to restore high employment and allow wages to grow more in step with productivity so that household incomes can keep up with the growth of consumption and consumers can finance their expenditures out of income rather than debt.

With regard to exchange rate realignment, it should be recalled that the dollar’s fall thus
far has occurred disproportionally in relation to the “major” currencies of the other industrialized nations, so its future depreciation needs to occur more in relation to the “other” currencies of the emerging market and developing nations (not only China, but also all the other countries that would gain competitive advantages if China revalues and they don’t). In other words, the currency realignment will be easier (and possibly more acceptable to China) if is multilateral and not just a Chinese appreciation with the dollar. A lower dollar combined with the high prices of energy and transportation costs (both of which have rebounded since falling in 2009) can bring some industries back to the US, especially producers of heavy goods such as steel and furniture. This was already starting to happen before the trend was interrupted by the financial crisis and recession (see Rubin and Tal, 2008; Mui, 2008), and the trend may resume now that the dollar is back down and transportation costs are back up—provided that the recovery picks up steam.

Although a sustained lower dollar would eventually help to restore more balanced trade, we cannot count on global financial markets in a world of floating exchange rates to keep the dollar at an appropriately low level for rebalancing US trade. The US dollar is valued chiefly because of its still-preeminent role in global financial markets and as a central bank reserve asset. The dollar’s exchange rate is determined mainly by the relative demand for dollar-denominated assets versus assets denominated in other currencies, not by the requisites of balancing US trade.

In the long term, replacing the dollar with a global currency or currency basket as the world’s main reserve asset could possibly help to eliminate the dollar’s recurrent overvaluation due to financial market factors, but the political prospects for such a new global monetary system seem dim at present. More immediately, an international agreement to manage the exchange rates of the major currencies within target zones—similar to the “Plaza Accord” of the late 1980s—could help to moderate global trade imbalances. President Barack Obama tried to get the
international community to agree on quantitative limits on current account imbalances and
currency market intervention at the G20 summit in Seoul, South Korea, in November 2010, but
ran into strong resistance from the surplus countries and left with only a vague commitment to
continue negotiations on the subject.

In the end, the US is stuck in somewhat of the same situation in which it found itself in
the late 1960s and early 1970s under the old Bretton Woods system of adjustable pegs, as a result
of being the “nth country” in a world of n currencies but only n–1 exchange rates. Once again,
this country lacks enough policy levers to reduce its own trade deficit at an acceptable domestic
cost (i.e., without a permanently depressed economy), while the surplus countries lack incentives
to cooperate. As a result, US policy makers may need to think “outside the box” about
unconventional remedies.

If international cooperative efforts fail, the US should consider adopting an across-the-
board tariff surcharge, as allowed for balance-of-payments purposes under Article XII of the
General Agreement on Tariffs and Trade (which has been incorporated into the WTO—see
Stewart and Drake, 2009). If the tariff was across-the-board and not just targeted on China, it
would not be discriminatory—and the fact that the tariff hit other countries (for example, EU
members) would only encourage them to join efforts to pressure the currency manipulators to
cease and desist.18 Alternatively, there have been proposals for an import certificate program, in
which the right to import goods would be auctioned or sold to companies who purchased
certificates from either exporters (Buffet, 2003) or the government (Papadimitriou et al., 2008),
with the quantity of certificates limited so as to achieve a target level for the trade balance. My
view is that import certificate schemes would be unduly complex to administer, and a tariff is
both technically simpler and (at least marginally) more politically feasible (see Blecker, 2009).
The US would be required by the WTO to consult with other countries if it put any type of import restriction into effect, and such consultations could lead to negotiations over adjustments that could make actual implementation of the restriction unnecessary. Such a positive outcome would be more likely if the implementation of the import restriction was made contingent on the US trade deficit being above some threshold (for example, 2% of GDP at full employment). This would hopefully motivate the surplus countries to find other ways to reduce their trade surpluses with the US, such as by letting their currencies appreciate or opening their markets more to US exports.

In the absence of such efforts, it is possible that the US will continue to muddle through with a large trade deficit, a depressed industrial sector, and a growing external debt for a long time, with at best a very slow and gradual reduction of the trade deficit if the dollar falls again and remains low. Although one does not want to “cry wolf,” the recent collapse of the US housing bubble and the ensuing financial crisis remind us that unsustainable situations sometimes end very abruptly and unexpectedly, with often dire consequences when they do. Having seen what a “hard landing” looks like in the housing market and on Wall Street, one would hope that both the US and other countries would want to avoid finding out what one would look like in international currency markets and global trade relations.
Endnotes

1 Scott (2008) estimates that 5.6 million jobs were lost or displaced by the non-oil trade deficit as of 2007. Mishel et al. (2009, pp. 186-200) analyze how trade pressures (not only the deficit, but also low-wage competition and globalization generally) have contributed to rising inequality and stagnant incomes for most US families.

2 Chinn (2010, p. 2) identifies five different explanations for the rise of the global trade imbalances and the US deficit: “(1) trends in saving and investment balances [including the fiscal balance], (2) the intertemporal approach, (3) mercantilist behavior [by the surplus countries], (4) the global saving glut, and (5) distortions in financial markets.” Chinn effectively admits that (2) has no empirical support. The four other explanations are all discussed below.

3 Kregel (2008) contends that global trade surpluses are largely attributable to “catching-up by late industrializing developing countries.” This characterization does apply to China and some other East Asian nations (e.g., Taiwan), but not to many other late industrializers (such as India and Brazil) who do not rely on large trade surpluses. In fact, only a few developing or emerging market nations have large trade surpluses, and many of these are major resource exporters rather than late industrializers. Japan and Germany have the second and third largest trade surpluses, but cannot be considered late industrializers today (even if they were in the past).

4 The current account includes net international investment income and net transfer payments in addition to net exports of goods and services. For the US, net investment income is normally positive and net transfers are normally negative, and these two have largely offset each other except for a few periods in the late 1970s and early 1990s.

5 In this paragraph, dollar values for the US current account are from US Bureau of Economic Analysis (BEA, 2010d), Table 1, but the current account as a percentage of GDP is calculated from data in US BEA (2010c), where the current account is measured by “net lending or borrowing” from Table 5.1 and GDP is from Table 1.1.5.

6 For example, in 2010Q2, the GDP growth rate would have been 5.2% instead of 1.7%, if not for the decrease in net exports during that quarter; similarly, in 2010Q3, the growth rate would have been 4.0% instead of 2.0%. Data are from US BEA (2010a), Table 2; data for 2010Q3 are advance estimates.

7 The “broad” index measures the dollars’ value relative to 26 other currencies from countries that collectively account for more than 90% of US trade (Loretan, 2005).

8 This is the famous “J-curve” pattern, named for the tendency of the trade balance to worsen in the first year or two after a currency devaluation and then to improve subsequently.

9 The “other important trading partners” index includes the 19 currencies from the broad index that are not included in the major currencies index (Loretan, 2005). As of 2008, developing and emerging market countries all together (including ones not included in the exchange rate index shown here) accounted for 57.3% of US goods imports and 69.5% of the goods trade deficit (calculated from data in US BEA, 2010d, Table 2a). See also Krugman (2008) on the changing country composition of U.S. imports and its impact on U.S. wages.

10 Chinn (2005) insists that the twin deficit connection was important during the early 2000s, but Chinn (2010) admits that this was an exceptional period.

11 In these estimates, both the current account and fiscal balance are measured as ratios to GDP, relative to the GDP-weighted world average for each variable.

12 For example, Chinn et al. (2010) include the following variables in their baseline specification: initial net foreign assets, relative income (level and squared), dependency ratio (young and old), an index of financial development, terms of trade volatility, average GDP growth, trade openness, an oil exporting dummy, and time fixed effects. Their extended model includes additional indicators of financial institutions and financial openness and interactive terms.

13 This term is borrowed from Bibow (2008), who somewhat unfairly accuses Bernanke of resting his argument on the “loanable funds” theory of interest rates. Although Bibow’s criticisms of the latter are apt, Bernanke’s version of the saving glut argument focuses mainly on explaining trade imbalances and does not emphasize effects on interest rates.
14 See Chinn (2010) for an exposition of this argument and Bibow (2008) for a theoretical critique.

15 To his credit, Bernanke (2005) recognizes that a substantial part of the net financial outflows from emerging market countries are the result of intervention by central banks, rather than the autonomous operation of private capital market. However, he underestimates how much these interventionist policies have gone hand in hand with mercantilist strategies of undervalued currencies and export promotion.

16 From 1994 until early 2005, China kept the yuan fixed at approximately 8.28 per US dollar. Starting in July 2005, China allowed the yuan to appreciate very gradually until July 2008, when the exchange rate was effectively re-pegged at around 6.83 per dollar. The gradual rise of the yuan resumed in June 2010, but the exchange rate fell to only 6.66 as of October 2010. Data are from US Federal Reserve (2010a).

17 This ratio declined from almost 6:1 in 2005 to just over 4:1 in 2009. Whether this is the beginning of a long-term trend or merely a result of the greater cyclical slowdown in the US economy remains to be seen.

18 The US might be legally obligated to exempt partner countries in free trade agreements, especially NAFTA members Mexico and Canada, from such a tariff. This would not necessarily be a bad thing, however, because regional trade in North America supports US industries and employment much more than importing from other regions like East Asia that buy much less US products (Blecker and Esquivel, 2010).
References


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