

World economy needs balancing, but how?

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Not so long ago, it looked as if the US was getting over its propensity to run unsustainable trade deficits and the world economy could move to "rebalancing" – meaning that its growth did not depend on unsustainable debt growth in any major member. After a promising start in rebalancing, the world once again faces the danger of keeling over because of the debt crisis in Europe.

US trade deficits, both goods and services, had gradually fallen from a record 760 billion dollar in 2006, to 700 billion dollar in 2007 and 2008, and then plunged to a recession low of 380 billion dollar in 2009. The first half of 2010, however, deteriorated with a 500 billion dollar annual deficit rate, driven in part by a sharp jump in imports from China.

China's overall exports had jumped 46% in May-June, with a monthly 20 billion dollar trade surplus. Threats to impose tariffs on Chinese exports to the US to offset what's termed unfair currency manipulation have only been put on hold given China's promise to let its currency float a little, gradually. Is the world ready to rebalance or return to the unbalanced state?

At the start of 2010, the US was already coming out of the financial crisis with stronger growth than either Europe or Japan. This naturally makes US imports grow in line with US income, while US exports grow more in line with growth in other countries. The benefit of a weaker dollar had helped US exports, but is now offset by a weaker euro and austerity moves that may create negative or feeble growth in large parts of the euro zone.

Doubts about the soundness of even sovereign debt of weaker euro members and the 1 trillion dollar exposure of French and German banks to debt from those economies suggest that it may be some time before these euro-area problems are sorted out, despite the "stress tests" that critics claim were rigged to give cheerful answers.

The UK, heavily dependent on an imploding financial sector, faces stiff austerity and possible return to recession. Japan's new prime minister also seems likely to exert much more fiscal discipline than his predecessors.

In other words, the rich world is troubled, and these

troubles have implications for the US economy and trade balance in both direct and indirect ways.

The direct ways are obvious. Weaker currencies of trading partners and overseas recessions mean more US imports and fewer US exports. A major potential pillar of a US economic recovery is being demolished by the slowdown in other OECD economies. The 15 million US unemployed have scant chance of finding work soon if private-sector job growth does not accelerate from the 100,000 new jobs a month added so far. Labour-force growth alone usually adds more workers.

These economic shocks have an impact on China. China probably had considered a continuation of moderate strengthening of its currency, a process started in 2005. But in mid-2008, with its exports shrinking, it stopped its currency appreciation, and the euro crisis has added to its reluctance to restart. If China strengthens its currency against the dollar when other nations devalue their currencies, then it would again face declining exports.

While recent wage inflation in China has the potential to eventually create stronger internal demand growth, it will take a while for that to make up for exports. Such rapid wage growth will also allow the real value of the yuan to appreciate, just as if the nominal rate continued to strengthen. The real value of a currency is its nominal value corrected for differences in inflation, and inflation in China is rising, due in part to its insistence on maintaining the yuan at a fixed rate against the dollar.

If the US goes ahead and imposes tariffs of 15% to 25% on China to offset under-valuation – as US Congress sees it – of the yuan, this is likely to start a trade war with many copying the US. This would potentially repeat the 1930's, when the world trading system collapsed due to rising protectionism in major countries. China would no doubt protest – and many economists would agree – that bilateral trade balances mean little and lower fiscal deficits would help the US economy rebalance.

Yet, the US itself is in a tough spot. It can no longer be the consumer of last resort for the global economy. Its banks are still weak and reluctant to lend, despite massive support from the Troubled Asset Relief Program and various Federal Reserve

programs. Real estate is still soft and could inflict further losses on balance sheets of banks and consumers. Interest rates are already near zero, and inflation is less of a threat than deflation at the moment.

The nation has about 10% official unemployment – over 15% if discouraged, and involuntary part-time workers are counted. Many of the unemployed have been out of work for more than six months and face a dismal future with limited government support or job prospects. The growing trade deficit cut 2.8% off growth in the second quarter, cutting job creation.

Meanwhile, a resurgent Republican opposition and some centrist Democrats are nervous about the size of federal fiscal deficits. This limits the ability of the federal government to offset weak state and local budgets and could lead to a double dip recession. If consumers and government are likely to subdue their spending, then only exports and corporate investment can strengthen demand.

But with banks reluctant to lend and bond markets nervous about even sovereign debt, the ability of many firms to get finance is limited. While US companies have strong balance sheets and a lot of cash, that's a positive only if they find reason to invest and hire. So far, that's been limited. With exports likely to weaken, the pressure is on to "do something."

It would help if surplus nations were less austere in their own fiscal policies, but Germany's move to decrease spending next year suggests that its conservatism is likely to be more influential than French willingness to spend.

Of course, fiscal sustainability must be considered. Most rich nations remain on a path of excessive fiscal deficits. They must figure out a way to spend less or tax more so that debt does not increase so much that default or inflation are the only exits.

If China could hasten its own internal structural transformation, this would be helpful, as it has accumulated large foreign currency reserves – nearly 2500 billion dollar – due in large part to its trade surpluses. The ability of these surpluses to be wisely invested abroad is an open question – it depends in part on how well various investments in raw materials look in a few years and also on how well their investments in rich-country bonds and stocks do.

In any case, if they were to move more closely to balance, it would allow others to either increase exports or cut imports. For example, a stronger yuan might help boost Mexico's economy, and Mexico tends to buy more from the US than China does.

In short, the world economy needs to continue moving to "rebalancing" and overcome the setback caused by the euro crisis. It could do that, but it will take a good deal of cooperation – possible but perhaps not likely. The "new normal" has yet to be discovered, and it may not be to everyone's liking.

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