

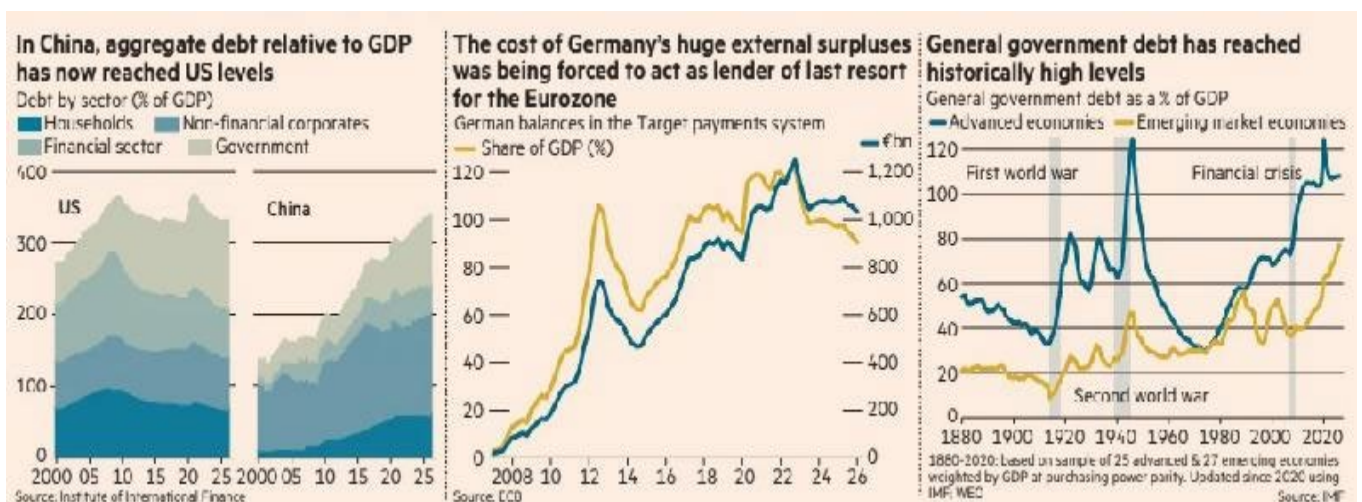
Why global imbalances matter

di Martin Wolf

They lie at the intersection of almost everything that matters in geoeconomics and geopolitics. As I noted last week, clashes over how to adjust external imbalances have recurred roughly every two decades since the 1980s. I should have added the 1920s and the 1960s. The latter ended with the collapse of the Bretton Woods system of fixed but adjustable exchange rates and, ultimately, with a world of floating rates (except in the Eurozone). The former ended with a global economic depression and a world war and so, among other things, with the creation of the Bretton Woods system in 1944. One of its products was the birth of the IMF, whose job it is to help manage such imbalances today.

Why is the management of global balance of payments imbalances both so difficult and so important? The short answer is that they lie at the intersection of almost everything that matters in global economics and politics: national power, full employment, industrial strength, financial stability, fiscal and monetary policies and management of exchange rates. In sum, they shape a large part of international relations.

We are now in a “neo-mercantilist” age. The mercantilist era of the 17th and 18th centuries — an era when trade surpluses were viewed as a measure of economic strength — was also a time of constant warfare. Today, as the president of the US meets China’s leader, external balances are again a powerful source of friction.



The 1920s and 1930s were an object lesson in how everything can go spectacularly wrong. After the first world war, the US became the dominant economic power globally and principal creditor country. This created economic and financial fragility in partner countries. The UK went back on the gold standard at the prewar parity in 1925. The result was deflation. Partly to help it, the Federal

Reserve, under the influence of Benjamin Strong, head of the New York Fed, eased monetary policy in 1927. This then enlarged the US stock-marketcum-financial bubble. The crash came in 1929, the Smoot-Hawley tariff in 1930 and, in the midst of the Great Depression, the emergence of Adolf Hitler as German chancellor in 1933.

The saga is uniquely frightful. But it also has subsequent echoes.

One is that surplus countries are not in as controlling a position as one might suppose. One source of weakness is that they will be subject to pressure (external and internal) to expand domestic demand (as was the US in the 1920s) and so reduce deflationary pressure on their partners. Exactly that happened to Japan in the 1980s and to China after the financial crisis of 2007-09. In both cases, the result was an unsustainable property bubble, which then duly burst.

Germany found itself in a not dissimilar situation during the Eurozone crisis. But, in the context of the monetary union, its choice was either to finance crisis-hit countries or let the single currency splinter. It chose the former, partly via so-called “target balances” within the currency union: the became a giant creditor.

The implication is that deficit countries, while ostensibly in a weaker position, have power, too.

Yes, credit to them can be cut off. But countries with structural surpluses of savings over investment and so external surpluses (such as China, Germany and Japan) have built their economies around excess supply of tradeable goods and services. Suddenly losing these may inflict a slump. Moralists in surplus countries complain the profligacy of deficit countries. But they need them.

The difficulty is finding deficit countries that are not just sufficiently creditworthy, but are so on a sufficiently large scale. Many emerging and developing countries have tried large-scale borrowing. But they have then mostly had to borrow in liabilities denominated in a foreign currency. This is risky for them, because, in a crisis, their central banks cannot create the money creditors want: so, they need an external rescuer. Unfortunately, the IMF is not always able to do the job.

So, after the Eurozone crisis demolished the creditworthiness of its deficit countries, the dominant deficit countries have become the US and (to a far lesser extent) the UK, both of which can (so far) borrow freely in their own currencies. In practice, the US has become the predominant balancer of the global balance of payments: its deficits offset the surpluses elsewhere.

Deficit countries, however, tend to have two problematic features: large expansion in domestic indebtedness and weakened production of tradeable goods (and services). This then creates political problems at home. Today, those problems are centred on the US. Donald Trump’s presidency, his aggressive tariff wars and the efforts of Scott Bessent, the Treasury secretary, to sustain global demand for US Treasury bonds are all symptoms of these difficulties. So is the pervasive financial fragility noted by worried observers.

The fundamental point, as John Maynard Keynes insisted, is that none of these challenges will be managed automatically by markets, partly because financial markets are so fragile and partly because anything that both affects and reflects domestic and global prosperity is always a focus of political power. It has been ever so: even the 19th century, which was the age of laissezfaire, was also an age of empire.

If the era of liberal capitalism is now over, something needs to replace it that does not also blow up the world economy. At present, however, we are on a path to financial crises related in part to the stubborn persistence of imbalances and to the unique and, in my view, unsustainable roles of the US (and UK) as balancers of the world system. Ultimately, this will and must change. How it will do so, we do not as yet know.