21 The political economy of rebalancing

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The global imbalances of the past decade were an underlying cause of the global crisis. This chapter argues that these imbalances are no longer sustainable and there is little doubt that the world economy will have to adjust to a new reality. The challenges of the next decade are two-fold: to manage political conflicts within countries, and to manage political conflicts among countries.

For fifteen years, macroeconomic imbalances, and concomitant international financial flows, have been a central feature of the world economy. One group of countries has borrowed heavily from the rest of the world, largely to finance increased consumption. Another set of countries has provided the goods, and the financing. The result was a decade and more in which borrowing countries ran huge deficits, while lending countries ran huge surpluses.

These imbalances are not sustainable over the medium and long run. As the world struggles through the crisis and its aftermath, the principal long-term question will be how these imbalances can be reduced. All conceivable outcomes involve political difficulties. Within countries, there will be conflict over who will make the sacrifices necessary to rebalance the national economy. Among countries, there will be conflict over the distribution of the adjustment burden between surplus and deficit nations. The future path of world economic activity depends on whether, and how, these conflicts play themselves out.

The need for rebalancing

Since the late 1990s, the pattern of international financial flows has been a peculiar one. The US, the UK, Spain, Ireland, and a phalanx of other countries ran large current account deficits, sucking in foreign goods and foreign capital to pay for them. These deficit countries relied on debt-financed consumption as the engine of their economic growth.

The principal lenders were Japan, Germany, China, and the Persian Gulf states. These countries, in one way or another, based their economies on exports to the deficit nations, using their export earnings to finance the deficits. In some cases the surpluses were the result of private saving and investment behavior, driven by a combination of demography and government policy. In other cases – in particular, China – the surpluses were the result of deliberate government attempts to accumulate reserves rather than permit a currency appreciation. But whatever the reason, what tied this group of surplus countries together was that they relied on exports as the engine of their economic growth.

This model of international economic interaction will almost certainly prove unsustainable in the future. The major debtor nations have exhausted their willingness, and perhaps their ability, to incur further debts, while the major lenders show increasing signs of uneasiness about further lending.[1] Once emergency short-term measures to address the crisis are behind us, deficit and surplus countries alike will have to rework their relationship with the rest of the world economy. This "rebalancing," to reduce the previous imbalances, is not primarily a technical, or purely economic problem, but rather a political one.

Upon whose backs will these national economies, and the world economy, be rebalanced? This question is central to the aftermath of every international debt crisis, such as the one we are currently living through. There is little doubt that national economies, and the world economy, will have to adjust to a new reality. But who will bear the burden of adjustment? How will the cost of these adjustments be distributed, both among countries, and within countries?

Rebalancing within countries

1.Rebalancing in the deficit countries

Part of the burden of adjusting to a major rebalancing of international financial flows will certainly fall on the major debtor nations and their people. The principal borrowers will no longer be able to rely on running massive current account deficits. This will especially be the case given the very large additional debt burdens their governments have taken on during the crisis. Every major debtor country will, like the US, come out of the crisis with government debts roughly equal to (or larger than) the size of the national economy – a level which, if the historical record can be trusted, means they face a long period of slow growth and retrenchment (see Reinhart and Rogoff 2009).

The problems and prospects of rebalancing in deficit countries can be seen in the US. The country's foreign borrowing binge followed a well-known path. As capital flowed into the country, Americans were able to consume more than they produced, invest more than they saved, and the US government was able to spend more than it took in. The consumption boom had familiar sectoral effects. Some of the borrowed funds were spent on hard goods that enter easily into world trade, leading to an import surge and a ballooning trade deficit. The rest of the borrowing went to the consumption of non-tradable goods and services: education, health

1 This is not to say that deficits and surpluses are in themselves technically unsustainable. So long as lenders are willing to lend, and borrowers to borrow, capital flows of this sort could go on forever. The point, however, is that effects of further massive increases in debt levels are unlikely, in my view, to be politically sustainable, as neither borrowing nor lending societies appear willing to resume pre-2008 levels of capital flows. A related point is that the capital flows of the past decade are almost entirely from poor to rich countries, or among rich countries; while the latter can be defended on some grounds, the former is hard to justify economically.

care, financial services, and housing. The result was flush times for non-tradables sectors, especially finance, insurance, and real estate, while conditions were less favorable for tradables sectors (manufacturing and agriculture). These economic trends had attendant political effects. The political influence of the booming sectors, especially finance and housing, grew continually, while the influence of the lagging sectors (manufacturing and agriculture) faded.[2]

As the scale of capital inflows is reduced – eventually, in my view, dramatically – those relationships will turn around. The country will have to produce more than it consumes, save more that it invests, and the US government will have to take in more than it spends in current costs. This implies serious austerity measures to restrict consumption, encourage savings, and reduce the government budget deficit. Americans – like the British, Irish, Spaniards and others – face a decade of reduced consumption, flat or declining real wages, and a stagnant standard of living. The sectoral effects will be a mirror image of the upswing. Rebalancing implies not only reducing spending, but switching it: increasing exports, stimulating tradable goods industries and reducing the importance of non-tradables. Hard as it may be to imagine now, the prospects are for a reduced economic role for the financial, insurance, and real estate complex that has been so central to the American political economy.

None of these adjustments will be politically easy. The austerity measures and compression of consumption ask Americans to put up with a long period of hardship. This is particularly difficult politically because even during the boom there was a widespread feeling that the benefits of economic growth were not evenly distributed; and in fact this feeling was accurate, as two-thirds of the country's income growth between 2002 and 2007 was captured by the wealthiest one percent of American households (see Saez 2007). There is already a widespread sentiment – reflected in the dramatic upsurge of populist rhetoric – that those who benefited from the boom are not paying their fair share of the retrenchment, while those being asked to sacrifice did not gain much from the previous expansion.

Both the broad public anger about the distributional effects of the crisis and its aftermath, and the political impact of the inevitable sectoral shifts in the economy, will make for hard times. The US, like other countries in similar positions, faces a very difficult next ten years. It will not be easy simultaneously to restore macroeconomic balance, create the conditions for future growth, and maintain a reasonable social consensus. Most of the government's, and the society's, efforts are likely to be expended in this effort.

2 Some might argue that political influence caused the sectoral pattern, rather than being caused by it, especially given the general tilt of the ruling Republicans toward the housing and financial services industries. However, the sectoral effects are very similar to dozens of previous capital inflow experiences, and very similar to those experienced by other deficit countries of many different partisan stripes. Partisan and other political factors may have heightened the impact of the underlying macroeconomic trends, but they did not create them.

2.Rebalancing in the surplus countries.

It is not just the major debtors that will have to undertake substantial, politically complicated, changes; the major creditor countries also face significant adjustments. Even if Germany, Japan, China, and others wanted to continue to run the kinds of surpluses they have gotten used to, their previous markets will be limiting their demand for imports. They have to reduce their dependence on exports, which implies that they have to increase domestic production for domestic consumption. Exporters will be less favored than they were in the upswing, as their economies turn away from relying on the export sector and toward the promotion of domestic consumption and the domestic service sectors. The surplus countries will of necessity turn inward.

Turning these export-oriented economies toward domestic markets will be politically difficult. In China, for example, the manufactured export sector has been at the center of the country's economic, social, and political order for decades, and it is almost certain that it will not be easy to reduce its economic importance. The country's political system has been heavily biased toward export manufacturing, and toward the coastal provinces where it is based. Chinese politics and policies have also strongly privileged investment over consumption – and investors over consumers. Changing this emphasis is not primarily a technical matter; it involves shifting decades-long patterns of social, political, and economic influence. In China and the other surplus countries, as in the deficit countries, rebalancing implies a fundamental change in the center of gravity of the economic, and therefore political, life of the societies in question.

Rebalancing, then, raises again the problem of winners and losers. This was true in the 1930s. It was true after the debt crisis of the 1980s in Latin America, or that of 1997-1998 in East Asia. It will be true again in the decade to come. Now, as in the past, economic changes brought on by the crises may also lead to fundamental political change, as winners became losers, losers became winners, and political conflicts ensue. These domestic political conflicts are certain to spill over into conflicts among nations.

Rebalancing among countries

Given the inevitable domestic conflicts between the winners and losers from rebalancing within countries, there are powerful incentives for governments to push some of the adjustment burden onto other nations. Debtors will attempt to force their creditors to pay some part of the price of debts gone bad. After all, debt crises create as many problems for creditors as for debtors – as Keynes put it: "If you owe your bank manager a hundred pounds, you have a problem. If you owe a million, it has." Debtors can inflate or depreciate away some of their debts. If, as in the case of members of the Eurozone, this option is not available, they can insist that their debts be renegotiated or that their governments be bailed out – at the expense of creditors, and the governments of their Eurozone partners. Creditors also have tools in their arsenals – including undertaking little or no new lending – and experience indicates that cross-border debt problems are rarely resolved without conflict.

There will also be international conflicts about the measures countries take to attempt to rebalance. The most obvious will be over trade, as deficit countries struggle to increase exports and restrain imports while surplus countries are in most cases still heavily oriented toward exports. Attempts by countries like the US to trim the trade deficit will almost certainly include aggressive measures against imports, as American industries increase their demands for import protection. There may also be insistent attempts to stimulate exports, including by trying to force open foreign markets with unilateral threats of retaliation. And while the US will not find it easy to weaken the dollar so long as the currency's safe-haven role persists, it can certainly pressure trading partners to appreciate their currencies.

While heavily indebted members of the Eurozone do not have the option of engineering country-specific inflation or depreciation to reduce their real debt burden and facilitate adjustment, they can attempt to influence ECB policy in this direction. The most powerful bargaining chip the Eurozone debtors have is the havoc a Eurozone sovereign default would wreak on financial markets throughout the EU; faced with a choice between this and looser policy than it might like, the ECB is likely to choose the latter. All in all, national attempts to get other countries to share in paying the price of adjustment are almost certain to heighten international conflicts over commercial, financial, and currency policy.

The case of the renminbi

International conflicts over currency policy are likely to intensify as the world economy rebalances, with China and the US the principal actors – a trend that revives the specter of "competitive devaluations," so central to the trade and currency wars of the 1930s. Since it opened to the world economy in 1979, China has kept the renminbi depreciated. The value of this policy for China can be debated – certainly it punishes Chinese consumers in favor of export sectors, although plenty of analysts are sympathetic to a weak-currency policy for a developing country (see Rodik 2008) – but there is little doubt that a weak renminbi increases competitive pressures on manufacturers who compete with the Chinese. Indeed, the growing chorus of protests by American industry led 130 Congressmen and Senators to condemn China in March 2010, writing in a joint statement: "Maintaining its currency at a devalued exchange rate provides a subsidy to Chinese companies and unfairly disadvantages foreign competitors." (Palmer 2010).

A weak renminbi encourages US imports from China and discourages US exports to China, at a time when the US needs to reduce its imports and increase its exports. Some might welcome the implicit subsidy to US consumers reflected by cheap Chinese imports. But at this point America's economic policy agenda is dominated by the need to reduce consumption, increase savings, reduce imports, and increase exports – all of which are hampered by a weak renminbi.

However, the Chinese will resist what one Foreign Ministry spokesman called "wrongful accusations and pressure." (Wong and Landler 2010) In language reminiscent of the currency wars of the 1930s, Premier Wen has insisted: "A country's exchange rate policy and its exchange rates should depend on its national economy and economic situation." Chung, Olivia (2010), "Wen hints at yuan move," Asia Times, 16 March. In the face of increasingly heated American rhetoric, one Chinese editorialist wrote, "A trade war would be regrettable, but creating a long-term deterrent to US protectionism may require retaliation." (Schuman 2009).

The US-China currency conflict is emblematic of the domestic and international conflicts the crisis will spark and deepen. It demonstrates how the aftermath of the crisis is likely to reduce the interests of major governments in international economic cooperation. It is not that the global economy will become irrelevant, for the depth and breadth of international commercial and financial ties is extraordinary. It is, however, that the goals of major governments are likely to be more inward-looking than they have been. Their constituents will be more concerned about domestic matters, and less concerned about international ones, than they have in the recent past.

Prospects

The global macroeconomic imbalances of the past decade were the underlying cause of the crisis that erupted late in 2007. Even if we wanted to restore these imbalances, it is almost certain that they are no longer sustainable. The principal item on the international economic agenda is how to rebalance the world economy, and national economies within it. These interrelated tasks are extraordinarily challenging, and not primarily for technical reasons. They are challenging because they call into question established patterns of political power and economic influence, both within countries and among countries. The principal challenges of the next decade are two-fold, and closely related: to manage political conflicts within countries, and to manage political conflicts among countries.

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