Global imbalances and the simultaneous global economy

Comment on B. Eichengreen "The Blind Men and the Elephant"

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The story of groping parts of an elephant is another way of saying that the world economy is a complex simultaneous system – we cannot examine part of this in isolation and think we understand the whole. Popular though "single magic bullets" are in the face of economic problems, they over simplifiy and could even be dangerous as regards policy prescriptions. In the context of the US "imbalances" therefore, it is useful to have this review of all the various stories which have been told as explanations, with the overall picture painted being one in which a number of factors plausibly play a part (although some of the stories told do appear to fail the plausibility tests of the author).

It is important to understand this view because if many factors were involved in gradually creating the position we see today, then one way of returning to what may be called "a more comfortable position" is to help these factors to gradually unwind. In fact, to some extent, we may argue that this "unwinding" could even take place of its own accord (we recall the "invisible hand" here, and refer to changes already being seen in global trade balances). Radical shocks might work faster but are likely to be unpleasant for all concerned and not the preferred means of moving ahead.

The problem is that those who see the US current account deficit as "unsustainable" require *immediate action* to reduce the deficit and thus they expect something *radical* to happen *quickly*, either through policy changes or via financial markets forcing the issue. In a sense, these analysts do not really care how the current position came about - only that it must be cut quickly. They point to a build up of US external debt and the costs of servicing this debt as unsustainable. In this case, the debate simply revolves around how much (or little) can be achieved in terms of rapid cuts in the US trade deficit via exchange rate changes (probably not large enough) as opposed to cutting US demand (a relatively certain impact – what might be called the "Argentina" solution) or raising demand elsewhere in the world economy (uncertain to happen even if agreed to be a good idea).

In contrast, the gradualist approach will take a long time to have much impact on the world's trade imbalances - requiring fans to accept that the "unsustainable" may actually be "sustainable" for some time to come. This cause is not as hopeless as it may seem. Looking at US current account and capital account details, the current position may be sustainable. Firstly, it is clear that the deterioration in the (net) debt servicing component of the current account has been quite slight (in spite of the US having a long tradition of running current account deficits). Secondly, there are continuing substantial net private capital inflows into the US – the dollar is not reliant only on central banks building up forex reserves. This process of accumulating dollar assets could continue some way yet.

However, even if analysts need to be more careful about what they mean by "unsustainable" and how they estimate demand for dollars, it is also possible that investors might change their view and stop buying US assets. This could happen quite abruptly, even without any radical changes in global conditions – we simply cannot be certain. In which case, dollar turbulence would be likely. Even so, we should remain cautious about how much impact even this would have in reducing the US's trade deficit.

The most obvious conclusions to draw from the overall analysis are that

- Large US trade deficits look to be very persistent features of the global economy and they will not readily die down unless other major economies/currencies can offer to play the role in global financial markets that the US currently has to play almost alone.
- Dollar volatility is likely to continue and thus swings of 20-30% from year to year may well be

seen (but need not have a great impact on the US trade deficit).

- Arguably, it is more important for the global economy that US bond markets should remain stable, given the role played by the US as the global interest rate setter – the global economy seems relatively able to withstand dollar volatility as long as volatility in US bond markets is avoided.