The deficit tango

By Charles Wyplosz
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During the early 2000s, there were myriad warnings that the world economy was headed for a crisis, owing to large and persistent external imbalances. The doomsayers turned out to be only half right: the world economy did go into a tailspin, beginning in the summer of 2007, but not because of the imbalances.

Instead, the Great Financial Crisis was rooted primarily in excessive risk-taking by financial intermediaries – a result of the poor regulation and supervision that emerged from earlier financial liberalization. Current-account balances did not even correlate with performance through that crisis.

To be sure, within the eurozone, those countries with large and persistent external deficits were hit hard by a crisis that surplus countries generally avoided. Yet Australia's current account has been in deficit every year since 1975, with the gap averaging about 4% of GDP, and it made it through the crisis and subsequent recession virtually unscathed.

At the opposite end of the spectrum, Switzerland's current-account surplus has averaged 7.8% of GDP since 1981. It peaked at 14.9% of GDP in 2010, and in 2016, it still stood at 12%. Yet the crisis inflicted significant damage on the Swiss economy, because it hit the country's two largest banks hard.

Today, much of the world remains fixated on current-account imbalances. But most observers still misunderstand what these imbalances really mean.

Minding the gap

Economists have made a specialty of disagreeing about the causes and policy implications of large external imbalances. Current accounts are endogenous, driven by a host of factors, domestic and foreign, which are also endogenous, driven by another host of factors, and so on.

Faced with such a complex situation, many observers take the simple route, choosing one or perhaps two – rarely three or more – "causes" that they deem exogenous. Based on those causes, they offer sweeping recommendations, which reflect hidden beliefs backed by unspecified assumptions.

Nothing better illustrates how this type of reasoning can go wrong than the current row, incited by US President Donald Trump, about US deficits and German surpluses. It seems obvious to Trump and the economic nationalists advising him that Germany's current-account surplus is the counterpart of America's deficit, and vice versa. As a result, they assume that the US deficit will be reduced when Germany's surplus shrinks.

This assumption is, as Trump might say, "bigly" wrong. But so is the conclusion, reached by some Germans, that Germany's surplus will shrink when America's deficit is reduced – a conclusion based on the assumption that the US deficit is exogenous, and the German surplus is endogenous.

Equally misguided is the widely popular view that Germany's surplus reflects the country's superior productivity, rooted in its engineering prowess and wage moderation. Yes, when German goods and services sell well around the world, export earnings are high. But at the heart of the issue is what Germany does with those earnings: rather than spend them on imports, it saves a large share of them.

The competitiveness chimera

One definition of the current account is the difference between suitably defined export and import earnings – an interpretation that leads naturally to a focus on competitiveness. But competitiveness is an elusive concept. Indeed, the Nobel laureate economist Paul Krugman has called it a dangerous obsession.

Competitiveness encompasses not only the prices of goods and services, but also their quality, production costs, and the processes by which they are transported and delivered. It is one of those endogenous variables that respond to a large number of factors, such as firms' business strategies and the evolution and structure of labor markets, including welfare systems. Given this, a focus on any one variable is likely to produce misleading results.

If one focuses only on price levels, for example, it would be difficult to understand how Switzerland retains a large current-account surplus, even though its currency, the franc, is notoriously overvalued. Likewise, price levels can't explain how the US has maintained a current-account deficit since 1984, given wide fluctuations in the dollar's exchange rate over that period. Today, the US deficit stands at $116.8 billion, despite little indication that the dollar is overvalued.

None of this is to say that competitiveness does not matter. But competitiveness is more a symptom than a cause of what is happening in the economy, and therefore should be viewed as just one clue as to what drives current-account imbalances.

The borrower's dilemma

The other definition of the current account – a country's saving or borrowing *vis-à-vis* the rest of the world – is much more illuminating. It certainly reflects more closely the primary concern about current-account deficits: that they result from excessive external borrowing. As long as deficits persist, the logic goes, external debt will keep growing until the country is unable to repay it.

But here, too, the prevailing assumptions may be faulty. If a country borrows heavily to finance productive investment, ensuring that the rate of return on the investment exceeds borrowing costs, more borrowing would translate into more wealth. In this situation, a country should not have any difficulty servicing its debt, as has been the case with Australia for decades.

If a country borrows heavily to support spending, however, the outcome is less straightforward. If the externally financed spending is private, the implication is that a large number of people are borrowing from many different financial intermediaries. As long as these financial intermediaries exert normal due diligence, the presumption is that most of the borrowers will be able to honor their debts.

The risks are greater when private actors borrow from domestic intermediaries that borrow externally, because a lack of vigilance on the part of those intermediaries could result in non-performing loans. That may force the intermediary to default to foreign lenders, who had assumed that they were not taking big risks.

Facing large defaults, foreign financial intermediaries may then fail as well, possibly even bringing down their national financial systems. That is what happened in 2007-2008, when the subprime-mortgage crisis in the US morphed into a global financial crisis. It is also what happened in Spain and Ireland shortly after.

But it is excessive public spending financed by external borrowing that is most worrisome, because highly indebted governments can default more easily than private entities. Unlike firms and households, states cannot be closed down or forced to sell assets. Moreover, they may have some political leverage, as was the case with Greece and Portugal during the euro crisis.

An awareness of these risks may cause foreign lenders, rightly or wrongly, to panic and stop lending to a country with large external debts, making it impossible for that country to finance its ongoing deficit. What is ironic about these sudden stops is that they can be the catalyst of the very crisis that international lenders fear when they cut off lending – a crisis that may not have materialized otherwise. Arguably, the eurozone crisis was of this self-fulfilling variety.

These experiences invite three important observations. First, it usually takes too long for questions to arise about whether countries that borrow excessively are competitive or not. Uncompetitive countries therefore have plenty of time to indulge in buying goods and services abroad using borrowed money.

Of course, for that to happen, they must find willing lenders abroad. This leads to the second observation: imprudent lending – whether motivated by carelessness or the expectation of a bailout if things go wrong – is always the root cause of persistent high deficits that finance private or public spending in excess of earnings. This takes us into the thicket of financial regulation and supervision in the lending countries, a fundamental exogenous cause of financial crises seldom mentioned in debates about the dangers of current-account deficits and external debts.

The third observation is that large and persistent external deficits create vulnerability, because they result in the buildup of debt that can eventually become worrisome for lenders, while locking borrowers into an inescapable pattern of borrowing.

Dangerous surpluses?

While much attention is devoted to the risks posed by large deficits, it is generally assumed that a large and persistent surplus is innocuous. But that is not the case. After all, persistent surpluses occur only if, collectively, households, firms, or governments consistently spend less than they earn. That means that these actors save more than they borrow, and thus that the surplus must be invested abroad.

There is nothing fundamentally wrong with the decision to save, which may well be driven by sound logic. For firms, the objective may be to invest in production abroad, because they want to expand internationally, because production costs are lower elsewhere, or because the rates of return are higher where capital is scarcer. And households in an aging society – Trump's German *bête noire* comes to mind – may wish to save for future needs.

But saving is always a risky business. Countries that accumulate large external debts are at the mercy of actions taken in sometimes-faraway lands, which can trigger international contagion, as happened to Switzerland in 2008. Given this, prudent investment is critical.

Monetary unions present a special case in this regard, as Europe discovered in 2010. When the eurozone was created, it was assumed that current-account balances no longer mattered for member countries. There were even proposals to stop measuring them, just as states' current accounts are not measured in the US. Either carelessness, made possible by poor regulation and supervision, or the expectation of a bailout meant that, from lenders' perspective, there seemed to be no reason to assume that debt service would, sooner or later, hit a wall.

But it is only in a complete monetary union that current accounts do not matter, because a common set of financial rules is enforced effectively or because there is a white knight to save the day with a bailout. In the US, regulation and supervision failed to prevent the subprime crisis from morphing into a systemic crisis, but white knights (the US Treasury and the Federal Reserve) rushed to bail out troubled financial institutions, with the notorious exception of Lehman Brothers.

In the eurozone, by contrast, the economies with large and persistent deficits were hit hard by the crisis. They also received bailouts, but only after 2012, when European Central Bank President Mario Draghi declared that the ECB was ready to do "whatever it takes to preserve the euro." In this sense, the eurozone's real problem was not external borrowing, but the incompleteness of the eurozone monetary union, which delayed and constrained ECB action.

This experience is often taken as evidence that current accounts matter a lot in a monetary union. This conclusion has led to the adoption of the Macroeconomic Imbalance Procedure, which requires the European Commission to monitor external imbalances and, where necessary, to recommend reducing them.

But even this conclusion is flawed, because it neglects, once again, the fact that current-account imbalances are endogenous and subject to exogenous factors. In Greece and Portugal, current-account deficits were closely tied to large and persistent public deficits. In Cyprus, Ireland, and Spain, it was the private sector that had borrowed huge amounts. In all of these cases, external borrowing had been used for non-productive spending.

What about external competitiveness? Wages and prices began growing fast in all the crisis countries once they became eurozone members. But, given that prices and wages are among the ultimate endogenous variables, this was a symptom, not a cause. The true cause was strong loan-financed demand for locally produced goods and services (itself endogenous to financial exuberance allowed by faulty supervision) and, in some cases, overly generous public-sector wage increases.

Good deficit, bad deficit

The current preoccupation with large and persistent current-account imbalances is justified. But it rests on flawed assumptions. The truth is that all current-account imbalances are not created equal.

Consider the US, which ran large and persistent deficits throughout the nineteenth century – deficits that were used to finance the massive investment needs of the country's fast-growing population and vast geography. For the most part, the investments made were highly productive, and the foreign lenders who provided the funding largely became rich.

By contrast, Greece borrowed heavily in the 2000s to pay for unproductive consumption. That was a bad deficit, which not only hit the country hard, but also left foreign lenders badly exposed, though they were largely rescued. The Germans and the Swiss may have good reasons to run surpluses today, but this is a matter of debate.

Persistent imbalances are bad if – and only if – they reflect deep-rooted factors, which may well seem distant from the imbalances themselves. Of course, even if they are "good," they can fuel vulnerability, because financial markets might become concerned about the mounting external debt. That is why it is essential to watch imbalances carefully.

But it is critical that policy recommendations aim to tackle the root causes of vulnerability – such as lenders' assumption that they will not face consequences for their risk-taking – rather than symptoms like competitiveness. For private debts, this implies the need for proper regulation and supervision. For sovereign debts, international crisis-resolution schemes, such as those long proposed by the International Monetary Fund, must be deployed.

As the old saying goes, it takes two to tango. For every risky borrower, there is a careless lender ready to dip and twirl. And it is the lender who will ultimately decide when the music stops.

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