

Global imbalances are “unsustainable” says IMF

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According to the US Treasury Secretary, Paul O'Neill, there is no need for any concern about the widening American trade gap. The current account deficit, he maintains, is a “meaningless concept.” But that view is not shared in global financial institutions, in particular the International Monetary Fund, which has added its voice to warnings that sooner or later the growing external indebtedness of the US will have major international consequences.

In its *World Economic Outlook* report published last week, the IMF devoted part of a chapter to the growing structural imbalance in the world economy between the deficit nations, headed by the US, and the surplus nations, Japan and Europe.

Introducing the report, Kenneth Rogoff, the director of the IMF Research Department, said the study had been conducted to find whether the “constellation of global current account imbalances among the industrialised countries is sustainable.” History showed that it was not.

Rogoff said that while much attention had focused on the extent of the US current account deficit, the IMF study had taken a global perspective—one country’s deficit being another’s surplus. It found that there was now a gap equivalent to 2.5 percent of global gross domestic product between the current account surpluses of continental Europe and East Asia (above all the euro area and Japan) and the deficit countries, dominated by the United States. Relative to the size of trade flows these imbalances had risen to levels “almost never seen in industrial countries in the post-war era.”

The specific purpose of the study was to assess the risk of whether the imbalances would unwind quickly, leading to “disruptive” movements in exchange rates, or whether it was possible to redress them more slowly. From the analysis presented in the report, and the

present trends in the world economy, it seems that the latter prospect is by far the least likely.

The study began by noting that external imbalances across the major industrial regions had grown steadily during the course of the 1990s leading to “major concerns” about the “possibility of an abrupt and disruptive adjustment of major exchange rates.”

The potential for instability arises from the fact that the major global currency—the US dollar—is the currency of the nation with the largest external debt. As the study put it: “The international financial system has generally been at its most stable when the external position of the lead country is strong, such as Britain during the classical gold standard, and less stable when [the] external position of the lead country is under more strain.”

To say that the US financial position is “under strain” is something of an understatement. The total debt now stands at around \$2.3 trillion, equivalent to some 23 percent of GDP. If present trends continue, the external debt will double to around 40 percent of GDP by 2007.

The widening US balance of payments gap means that it requires a capital inflow of more than \$1 billion per day.

When the value of the dollar was increasing, as it was from 1995 to the beginning of this year, this inflow could be sustained. But conditions have now changed markedly.

Above all, the capital inflow into the US, and the consequent appreciation in the value of the dollar, was based on the expectation of increased profits. However, it is now clear that these heightened expectations were themselves a result of what the IMF euphemistically calls “financial excesses” associated with the information technology revolution.

The inflow of capital in search of higher profits led to

an appreciation of the US dollar, bringing a capital gain for foreign investors, and inducing a further capital inflow.

But this process could now start to start to unwind, setting off a major financial crisis, the potential size of which is indicated by figures contained in the report. It pointed out if the dollar were to reverse its appreciation since 1995, foreign holders of US assets would suffer losses equivalent to about 10 percent of US GDP.

Although the IMF does not make this point explicit, the danger is that under these conditions a sharp fall in the dollar, even to levels still well above those of 1995, could spark an expectation of further declines, leading to a stampede out of US assets.

However the situation unfolds, it is clear, in the words of the report, that the “current gaps between the growth in real domestic demand and real output” of the deficit countries “cannot be sustained indefinitely.”

In other words, the US cannot go on borrowing from the rest of the world to finance the excess of its spending over national income and real domestic demand will have to decline.

Such a process took place in the late 1980s. At that time, however, the effects on the world economy were cushioned by “buoyant demand in the euro area and Japan” reflecting the spending by the German government on reunification and an asset price bubble, respectively.

While these processes had a stabilising effect at the time, they proved to be unsustainable in the longer term leading to problems in the Japanese banking system and the German construction industry that have continued to the present.

Summing up the present situation, the report said it was “unlikely” that the euro zone and East Asia were in a position “to significantly offset a rapid deceleration in demand elsewhere.”

This is also something of an understatement. Far from leading an upturn in the world economy in the event of a fall off in US demand, the latest figures show that the euro zone is more dependent than ever on the US market to stimulate growth. In the second quarter of this year, increased domestic demand accounted for only a 0.1 percentage point of the increase in growth across the region.

According to the *Economist*, the annual rate of growth in the region during the second quarter was only

1.4 percent, with prospects for the third quarter looking even “grimmer.” “Germany’s growth may now be contracting again: its IFO business-sentiment index has fallen for three consecutive months. In the euro area, demand is being squeezed by a stronger currency, as well as by the fall in share prices. Many forecasters have revised their predictions for growth in 2002 to below 1 percent.”

The situation in Japan is, in many respects, even worse with the Bank of Japan (BoJ) now resorting to increasingly desperate measures to try to prevent a financial crisis. In its latest move, the BoJ announced last week that it would buy shares from the large portfolios held by the major banks in order to keep their capital adequacy ratios above international standards.

The continued stagnation of both the German and Japanese economies rules out the IMF’s preferred option of a smooth return to more normal conditions through a rundown in the value of the US dollar, and a decrease in US demand, balanced by an increase in demand from the rest of the world.

Far more likely, is a severe wrench in which the dollar falls sharply, demand in the US declines, leading to a further decline in global demand as growth in Europe and Asia declines because of the contraction in exports to the US market, thereby creating the conditions for a deepening world slump.



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