The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

The World Needs Deficits

By Sanjeev Sanyal

November 13, 2013



These days everyone seems to want to run a current-account surplus. China has long run large surpluses. The eurozone is now running even larger ones, with swings in southern Europe augmenting Germany's longstanding surpluses. Indeed, countries from Singapore to Russia are running large surpluses.

Meanwhile, America's external deficit — which for decades has helped to sustain surpluses elsewhere — is now smaller than it was before 2008, with many economists arguing that it should never revert to its previous levels and they argue that the shale-gas boom makes this unlikely, anyway. Financial markets have also made clear that the ability of other major deficit countries, like Brazil and India, to absorb capital flows is reaching its limit. Since the world is a closed system, this raises the question: Who will run the world's deficits?

Mainstream economists believe that the global economy should function as a balanced mechanical arrangement in which external surpluses and deficits are smoothed out over time. But periods of global economic expansion have virtually always been characterized by symbiotic imbalances.

One part of the world runs large deficits for a prolonged period, creating demand; another part of the world runs surpluses, financing its counterparts' deficits. This was true of Roman-Indian trade in the first and second centuries, and of the age of European exploration in the 16th century. It was also true of the two Bretton Woods monetary arrangements in which the U.S. ran the necessary deficits.

Admittedly, imbalanced systems create distortions. The Romans had to debase their coins, owing to the continuous loss of gold to India. The Spanish empire flooded the world with silver coins as it paid for its many wars. Bretton Woods I collapsed in 1971, when the dollar's peg to gold became untenable, and Bretton Woods II ended in 2008, owing to the misallocation of capital. But these distortions did not prevent unbalanced systems from enduring for long periods.

The only significant period of "balanced" economic expansion was in the early 19th century. The British East India Company deliberately imposed a triangular trade arrangement whereby Britain sold manufactured goods to India in order to buy opium, which it subsequently sold in China to finance the purchase of tea and other products. In other words, balanced global economic growth required war, colonization and large-scale drug trafficking.

So, what symbiotic imbalance will underpin the next round of global economic growth? Given that the current account is the difference between a country's saving and investment rates, both of which are heavily influenced by demographics, we need to consider rapid changes in population dynamics.

It would be convenient if global demographics were distributed in such a way that aging countries like China could run surpluses just when younger countries needed the capital. In reality, many major economies will be trying to save for retirement at the same time. Moreover, the younger countries are typically emerging markets, which have neither the scale nor the capacity to absorb the world's excess savings efficiently.

The U.S. is the main exception: it has both the required scale and the youngest population of any major developed country. Given this, it will once again fall to the U.S. to run the world's largest external deficit, in what could be dubbed Bretton Woods III.

It may seem appalling to expect such a highly indebted country to continue to run deficits; but the world is willing to finance the U.S. at negative real interest rates. Indeed, the main international concern has been policymakers' reluctance to raise the U.S. debt ceiling.

If the U.S. is unable or unwilling to run the required deficits, the global economy will flounder in a savings glut of low demand and cheap capital until another alternative emerges. Or perhaps the low cost of international capital will entice the U.S. to absorb some of the world's excess savings, triggering a new period of global expansion.

While a Bretton Woods III arrangement would inevitably generate its own distortions, it could last for years if the capital is invested sensibly. The prospect of its eventual demise is not a good reason to wait for some theoretical ideal of global balance to materialize. If history is any indication, we will be waiting for a long time.

Sanjeev Sanyal, Global Strategist at Deutsche Bank, was named "Young Global Leader 2010" by the World Economic Forum. © Project Syndicate

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