IS MERCANTILISM DOOMED TO FAIL?

China, Germany, and Japan and the Exhaustion of Debtor Countries

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BASIC TRADE IDENTITY

- Sum of global exports equals sum of global imports
- Implying that a country that increases *net* exports can only do so if some other country increases *net* imports
- In a global general equilibrium, if some country pursues policies that persistently lead to net exports, then there must be some other country (countries) that have net imports

COUNTRIES WITH PERSISTENT TRADE DEFICITS HAVE TWO PROBLEMS

1. It may be difficult to finance (cumulatively high levels of foreign indebtedness relative to GDP)
   - Especially if trade deficit arises from imported consumption goods

2. High levels of net imports weaken aggregate demand
   - To sustain full employment, governments may have to run a fiscal deficit
   - But that leads over time to high levels of national debts
   - Trade deficits can thus cause fiscal deficits (confirmed using Granger causality for at least one of G-7 countries)
     - Converse of standard “story” of fiscal deficits causing trade deficits

CONSEQUENCE

- Trade deficits are like hot potatoes
- Countries have learned the lesson—risks of persistent trade deficits
- But if one country takes action to limit its trade deficit, if surplus countries persist in their surpluses, some other country must face an increased trade deficit

DEFICIT OF LAST RESORT

- US has become, to a large extent, “deficit of last resort”
- As other countries take actions to reduce trade deficit, if surplus countries maintain policies to sustain surplus, then the US deficit essentially equals the sum of the surpluses
- But this situation is not sustainable

WHAT CAN (TRADE) DEFICIT COUNTRIES DO?

- Adjust exchange rate
  - But responses may be slow
  - And other countries may take countervailing actions
  - Not a real possibility for members of euro zone
    - They've joined the US as part of the deficit of last resort
    - Internal devaluation not effective substitute
      - Especially in the presence of euro-denominated debts
      - If it were, gold standard would not have posed a problem for adjustment in the Great Depression
  - More generally, exchange rates determined by capital flows as much as by trade, and in a world of unfettered capital flows, managing exchange rates may be difficult
    - Though preventing appreciation (an overvalued exchange rate) is easier than preventing depreciation (an undervalued exchange rate)

- Lowering imports
- And, with supply side responses, increasing exports
- Huge social and economic cost

NON-MARKET ADJUSTMENT MECHANISMS

- Buffett proposal
  - Need "chit" to import
  - Earned by exporting
  - Chits marketed
  - Ensures no trade deficit
  - Equivalent to having a multiple exchange rate (capital and trade account)

- But this "forces" either some other country to have an increased deficit, or surplus countries to eliminate surplus

MACROECONOMIC EXTERNALITIES

- Policies of one country have effects on others
- Surplus countries lower global aggregate demand
- And impose costs on all other countries
- And on systemic stability of the system
- Which is why Keynes argued for a tax on surplus countries

ARE THERE JUSTIFICATIONS FOR RUNNING A SURPLUS?

- Building up precautionary balances (reserves)
  - Especially relevant for commodity exporters, highly volatile prices
  - Understandable in the aftermath of the East Asian crisis, where those without adequate reserves paid such a high price
  - Reinforced by the experiences of the 2008 crisis, where those who had larger reserves did better
- Learning by doing (learning by exporting), key rationale for success of export led growth
- Demographics
  - Not good explanation of current patterns
- Whatever the validity of justification, in pursuing their own interests, surplus countries impose costs on others

REINFORCING A DYSFUNCTIONAL SYSTEM

- Dollar based reserve system means the US is exporting "T bills" rather than "automobiles"
  - But exporting T bills doesn't create job
  - System reinforces the role of the US as consumer and deficit of last resort
  - Accumulation of debts (IOU's) by others can lead to a variant of the Triffin Problem—confidence in the reserve currency erodes

- Move to a dollar-euro or dollar-euro-yen reserve system would "share" burden but not address underlying problems (and possibly create an even more unstable system)

ENDING AN UNSTABLE SYSTEM

- Is there anything that can be done to prevent surplus countries from running a surplus?
  - Yes—if deficit countries refuse to run a deficit
  - And especially, if deficit countries (US) refuses to be passive
    - What happens if surplus countries try to maintain surpluses, but other countries take actions to prevent a deficit?
  - And if, within the EU, the deficit countries insist that the surplus countries take actions to eliminate surplus
    - More important (and more efficient) than deficit countries responding

AN ALTERNATIVE FRAMEWORK FOR THE GLOBAL FINANCIAL SYSTEM

- A global reserve system
  - With provisions to discourage excessive surpluses
  - Helping countries—and the global economy—manage macroeconomic risks better
    - Increased reserve creation in periods of global slowdown
- Reform in WTO to allowing developing countries to engage in industrial policies
  - Reducing reliance on exchange rate policy for “export led growth” and economic transformation
- Global financial market regulation and capital account management
  - With a focus on limiting destabilizing short term capital flows
    - Especially in periods of crises
  - Acceptance of principles of managed exchange rate systems

- Globally coordinated monetary policy
  - With globalization, effects of monetary policy markedly different
    - Additional liquidity doesn’t stay in country creating it
    - What matters, to a large extent, is global aggregate demand
      - One large central bank can be taking out global liquidity as another adds it
    - Major effect of interest rate policies can be on exchange rates
      - Competitive devaluations can be counterproductive

CONCLUDING COMMENTS

- Surpluses are not created just to advance a mercantilist agenda
  - But there are valid reasons for developing countries to pursue industrial policies

- But whatever their rationale, surplus countries impose costs on others
  - And the persistence of these surpluses has led to outcomes that are not sustainable—"debtor and deficit exhaustion"

- Global instability is as much (or more) a result of the behavior of surplus countries as of deficit countries
  - Suggesting tone of indignation not justified
  - And the advice that others should follow their ways impossible—not everyone can run surpluses
- There are unilateral actions that deficit countries can take to rectify imbalances

GLOBAL REFORM

- But better would be reforms in the global financial and trade system
  - A global reserve system
  - A global regulatory system
  - Reform of the global trade system
  - Better coordination of global monetary policy