

# CENTER ON CAPITALISM AND SOCIETY

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Comments on Adjustment of International Imbalances  
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## *International adjustment of persistent payments imbalances*

1. We should agree that since the end of Bretton Woods fixed exchange rates we have been living with a fundamentally unstable international financial system, with neither an aggregate monetary anchor nor common “rules of the games” for macro-economic and exchange rate policies of the main countries and currency areas. Over time this system has generated imbalances in international payments that have proved unsustainable, leading eventually to a meltdown of the very core of the system, the US banking and financial markets.
2. A main feature of the system has been that international payment imbalances have tended to persist, rather than be corrected, and indeed to grow larger, giving rise to ever larger financial flows for their financing and to massive accumulation of international creditor and debtor positions, in an environment of increasingly free capital flows. Thus massive pools of money have been moving from market to market in chase for returns, giving rise to an unprecedented sequence of booms and busts and banking crises – from Latin America, to Japan, South East Asia, Russia, and the United States, climaxing in the global housing bubble of this decade, and its sorry end. There has been a direct and systematic relation between payment imbalances and the repeated bouts of financial instability that have plagued the world economy.
3. A second noteworthy feature of the system has been the continuing special role of the dollar and, hence, of US macro-financial policies in the functioning – or malfunctioning – of the system. Indeed if one proxy cause can be identified of the global housing boom, this is the combination of aggressive monetary and fiscal expansion in the US earlier in this decade: large fiscal deficits have broadened the external deficit, correspondingly swelling capital inflows from Asia to US financial markets; and aggressive monetary expansion has fuelled the asset price bubble not only at home, but worldwide via the amplifying effects of the foreign exchange interventions of the countries pegged to the dollar.
4. If this analysis can be shared, a main implication is that the system will remain unstable unless we can anchor it to a less unstable base and bring payment imbalances down to sustainable levels – which is per se an ill-defined concept – by means of agreed (and enforceable?) common rules on what national policies can and cannot do. Rules that would have to apply also to the United States. In addition, we also need some agreed rules on exchange rate policies and foreign exchange interventions, so as to let exchange rates adjust more flexibly to correct payment imbalances. This is a fine conclusion, not very surprising and fairly uncontroversial. It is of course easier said than done, and many difficult issues would have to be resolved in practice (cf. for one the recent book by Martin Wolf on “Fixing global finance”); but in the main we have a diagnosis and a policy recipe.
5. But is this the end of the story? I am not sure. Maybe we have to dig deeper and see whether there are more fundamental, or “structural” determinants of unstable national policies and resulting international imbalances. One such possible factor is low wage growth in advanced countries generated by globalization.
6. Low wage growth in advanced countries has been a constant feature of the past two decades, as a result of globalisation and technological change. We deluded ourselves that the problem should be resolved by investing in human capital and making all citizens of advanced countries active participants in the knowledge economy. In practice, it has not happened, and swathes of people in advanced countries have been struggling with stagnant or declining

real wages and cannot cope with competition from cheap labour from emerging countries: which has permanently lowered the **sustainable** – I stress the word sustainable – increase in domestic consumption in advanced countries.

7. There have been two main responses to this development. On one hand, we have the **thriffters**, the countries that do not like to live beyond their means, among which the paramount example is set by virtuous Germany. Japan would have liked not to be part of this group, but it was forced to join by the end of its home-made bubble. Their response to heightened competition in labour markets has been to invest in technology, in order to stay competitive, but also to tighten the belt of domestic income growth, every year a bit more, thus engineering a real exchange rate depreciation trough wage deflation: their success has led to enormous payment surpluses, at the cost of dismal growth, and has exported the pressure to reduce labour costs to their industrial trading partners. Indeed, the trading surplus of Germany largely concentrates within the eurozone, where we find the **second type of thriffters**, the **unsuccessful thriffters**: e.g. countries like Italy, Greece, Portugal. These countries have maintained their rigid labour markets, and have not been able to move fast enough up the technology ladder. The main response to stagnating productivity has been the dual labour market, where immigrant workers work more for much less. As a result wage growth has stagnated even more while investment I human capital has dropped.
8. Not surprisingly, resistance to open markets and globalisation has blossomed in Europe, while the eurozone has emerged as a zone of declining growth.
9. The group of thriffters also contains emerging countries in Asia, with disproportionate domestic saving and investment rates – which have led to massive overinvestment – as Ned Phelps noted this morning. For some of them, high net saving and external payment surpluses represent the insurance policy against a repetition of the currency crisis of the late 1990s, with attendant IMF imposed deflations. Whether these countries – notably China – can take on their shoulders the burden of providing the world economy with the net stimulus that it will need, remains unclear. For sure it will not happen without major domestic economic and political changes that are not yet in the cards.
10. The second main category of advanced countries has been the **profligates**, those living on unsustainable debt. The club was founded by Japan and Ireland in the 1980s; as I mentioned, Japan was forced to leave the club under duress. Its place was taken by the United States, soon joined by Spain and the United Kingdom, the newly freed countries in Eastern Europe and Russia (helped also by its gas and oil riches). The profligates road to high growth has been to engineer **sustained asset price booms – in stock market and housing** – that allow consumers to borrow ever larger amounts, using their swelling wealth as collateral, and thus maintain consumption growth well beyond the law of gravity. Many an economist started to believe that the formula for permanent happiness – the goldilock economy – had been discovered, until the house of cards collapsed.
11. The problem now is that among the former profligates the overhang from the party is going to last for long, as the record of past housing bubble crashes indicates clearly. The heroic US, UK, Spanish and Irish consumers, on which we counted for world growth, will not be able to start borrowing again and consume lavishly for quite some time – say, at least five years, maybe more. And their income will not grow, under the competitive pressure from low cost manufacturers in Asia. **Resistance against globalisation in these countries is bound to mount, now that the club of profligates has been disbanded and former members have joined the thriffters.**

12. Thus, we are left with a major policy puzzle for world adjustment: if wage and income growth cannot resume in advanced countries, **who will pull the world economy out of the slump where we are plunging?** Without being able to dwell on this for too long – it seems to me that a stable solution will not be found unless we can bring emerging countries **to accept higher standards for labour rights and environmental protection. Thus creating not only more room for rising wages in advanced countries, but also the needed basis for sustained expansion of domestic demand in the developing world.**

New York, 20 February 2009