

Current Account Imbalances, Debt Buildup, and Instability

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Abstract: Orthodox trade theory focuses on the reallocation of real resources through trade and ignores the monetary/financial and balance sheet aspects of trade. Once in a while, the Twin Deficits bogey is raised to warn about the perils of fiscal deficits, but current account deficits themselves are generally viewed benignly. In reality, growing current account deficits not only lead to an unsustainable buildup in external debt but also lead to a buildup in domestic debt, especially private sector debt. The resolution of these unsustainable trends does not generally occur smoothly through changes in prices and exchange rates but through painful adjustments in output and income. Persistent trade imbalances pose a threat to the global economy. They exacerbate financial imbalances, contribute to financial instability and economic crises, and thereby stoke political resentment to free trade.

Mainstream economics rarely concerns itself with current account deficits as a source of problem. The sanguine view of current account deficits stems from three inter-related ideas. First, trade imbalances are seen as self-correcting and temporary, especially if exchange rates are flexible. Second, since trade deficits are always exactly matched by capital inflows from abroad—an accounting identity—they are viewed as the result of matching saving with investment opportunities. Third, it is generally assumed that the liabilities created by deficits can be easily unwound by future surpluses.

Even when current account deficits sometimes cause worries, it is seen as a symptom of some deeper malaise. The following excerpt from an IMF report (Ghosh and Ramakrishnan, 2006) the conventional view of current account imbalances:

If the deficit reflects an excess of imports over exports, it may be indicative of competitiveness problems, but because the current account deficit also implies an excess of investment over savings, it could equally be pointing to a highly productive, growing economy. If the deficit reflects low savings rather than high investment, it could be caused by reckless fiscal policy or a consumption binge. Or it could reflect perfectly sensible intertemporal trade, perhaps because of a temporary shock or shifting demographics. Without knowing which of these is at play, it makes little sense to talk of a deficit being "good" or "bad": deficits reflect underlying economic trends, which may be desirable or undesirable for a country at a particular point in time.

Yet, as I argue in this paper, the mainstream view of current account imbalances ignores, among other things, their critical role in increasing financial fragility, both on the external and the domestic fronts. While, in theory, current account deficits could be financed substantially through equity investments, in practice, they tend to be disproportionately financed by debt. Thus, growing current account deficits lead to rising external debt. An even lesser known fact is that widening current account deficits lead to rising domestic leverage, especially in the private sector, with serious consequences for financial stability and future economic growth. The free-market resolutions of these imbalances do not happen smoothly via exchange rates but by severe economic contraction and prolonged economic weakness, with depressive effects on the rest of the world.

A Brief Digression: Sector Financial Balances

Sector financial balances and stock-flow consistent modeling is a useful framework for understanding the effect of financial flows on balance sheets and the feedback from balance sheets to the real economy. The British economist, Wynne Godley, developed the concept of sector financial balances from the national income and product accounts (Godley and Lavoie, 2012). Basically, the sector financial balance is an accounting identity that relates saving/investment decisions to the net accretion/reduction of financial asset position across the three major sectors of an economy—the private sector, the government sector, and the foreign sector. A sector runs a positive financial balance when its saving exceeds its investment and vice versa. We can write the sector financial in commonly understood terms as follows:

Government Sector Balance + Domestic Private Sector Balance = Current Account Balance

A sector running negative financial balances is either running down its cash balances or running up debt. Usually cash balances are insignificant over longer periods of time, and negative sector balances are closely related to a build-up in debt in the sector running negative balances. When a country runs a current account deficit, by definition, either the government or the domestic private sector or both are running deficits—that is, they are borrowing.

Another concept closely related to the sector financial balances framework is the profits perspective used by the Jerome Levy Forecasting Center. It is essentially the Levy-Kalecki profits identity:

Profits After Taxes = Net Investment – Household Saving – Government Saving + Current Account Surplus

The profits perspective starts with the simple premise that profits are the engine that drives capitalist economies. Profits motivate business to hire and invest. The profits equation is an accounting identity, but it also reflects the dynamic flows of funds (called profit sources) that result in profits in the aggregate. One thing that is clear from the profits equation is that a current account surplus is a profit source. Other things remaining the same, an increase in the current account surplus increases profits. Moreover, note that the domestic private profit sources—net investment and household saving—are credit sensitive. Investment, whether in equipment, structures, or housing, is credit dependent. Credit also enables households to spend beyond their current incomes, thereby reducing household saving—note, falling saving is a positive influence on profits in the short term. On the other hand, when a country runs a current account surplus—which is a positive profit source—it is generated not by domestic credit but by credit growth in other countries. In terms of the more familiar demand approach, the credit facilitating net demand is created elsewhere. We will come back to this discussion in a later section and see that the mercantilists were not as wrong as they are often portrayed to be.

The other important facet is the feedback from the buildup in debt to economic activity and financial stability. Although Irving Fisher wrote about Debt Deflation in the 1930s, economists had until the 2008 crisis ignored private debt. The dominant view is that debt is an epiphenomenon, reflecting the intertemporal optimization of savers and borrowers. However, Atif Mian and Amir Sufi in their seminal work—using zipcode level data on mortgages and spending—traced the channels through which the debt-fueled housing boom artificially boosted spending and caused the subsequent bust (Mian and Sufi, 2015). Since then, a plethora of research, using macro as well as micro data, has come to the conclusion that surging private sector leverage is an important harbinger of prolonged economic weakness if not crisis. The feedback loops between balance sheets and the economic activity—related to Soros’ concept of reflexivity in financial markets (Soros, 2013)—is the centerpiece of Hyman Minsky’s financial instability hypothesis (Minsky, 1992) as well as the stock-flow consistent modeling framework of Wynne Godley (Godley and Lavoie, 2012).

At this point, it is worth sketching out why instability arises. For a borrower, debt is a balance sheet transaction; it does not affect the current income statement. However, the spending financed by that debt generates income for someone else in the economy. Thus, debt-fueled spending generates income for many participants in the economy. For example, if a person takes out a home-equity loan and buys a car, it generates income for people working in the automobile industry. Workers in the automobile industry themselves may not be leveraged but their incomes are being generated by leverage elsewhere in the economy. Most people are not engaged in macroeconomic analysis and, even if they are, are unlikely to make the connection that their income is being driven by an unsustainable debt somewhere else in the economy; the linkages in the economy are far too complex. So, debt-fueled-spending tends to create unsustainable income gains that are viewed as permanent by individuals, who then increase their spending, creating a virtuous cycle. In the reverse, when firms and individuals are forced to deleverage, it represents a loss of income of other participants in the economy, who then start to pullback, triggering a vicious cycle. When a debt default happens, it is not a mere transfer of wealth from creditors to debtors. Both debtors and creditors experience losses—the former in expected income and the latter in actual wealth.

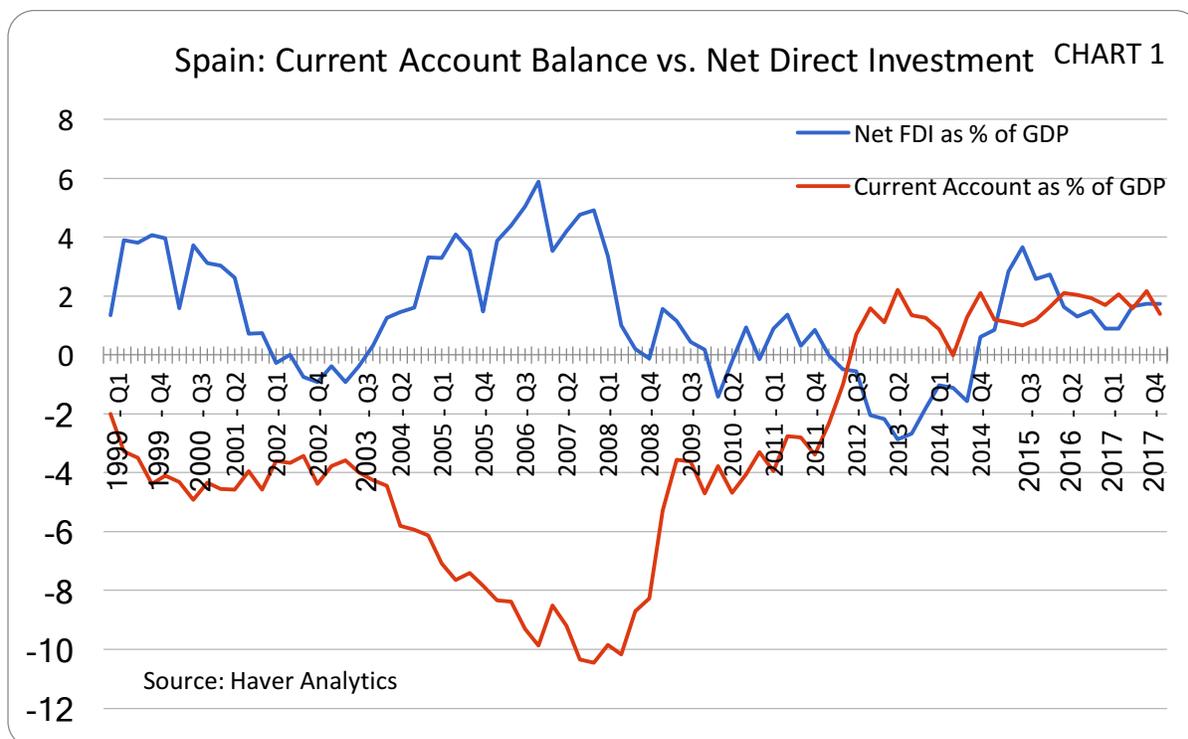
Current Account Deficits and External Debt

"Nothing, however, can be more absurd than this whole doctrine of the balance of trade, upon which, not only these restraints, but almost all the other regulations of commerce are founded."—Adam Smith

In many ways, international trade is but an extension of trade within a nation or even between individuals—the benefits stem from specialization. However, as with the case of all transactions, protracted imbalances carry with them balance sheet consequences. Adam Smith's summary rejection of trade imbalances as a source of potential problems is analogous to the mainstream's dismissal of private sector debt as a source of macroeconomic instability. Bernanke famously rejected the debt-deflation hypothesis as requiring implausible differences in marginal propensities to consume between the debtor and the creditor. The failure to understand debt and its interaction with the real economy extends to international trade and is the major reason why current account deficits are generally ignored until a crisis is staring us in the face.

If the current account were a mere epiphenomenon—the net result of comparative advantage, intertemporal optimization, and international portfolio choices—then there should not be any link between external debt and the current account. The link with gross external debt should be even weaker. Yet, the record clearly shows this to be not the case.

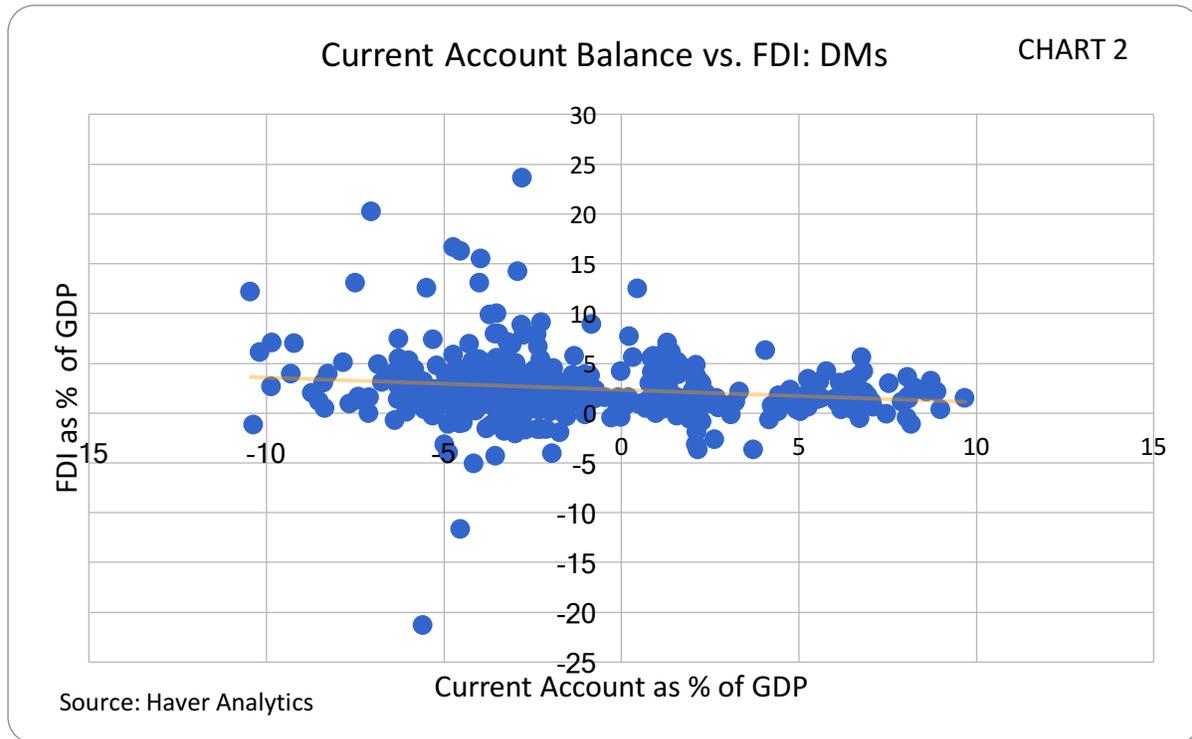
Sector financial balances framework says that a current account deficit results in a liability, but it does not say what form that liability will take. A current account deficit in theory can be entirely financed by foreign direct investment (FDI). If that FDI is in the form of equity, then worries of unstable debt dynamics are mitigated. There is an implicit assumption among many international trade and finance theorists that current account deficits are largely funded by foreign direct investment (FDI)—that is, equity flows. As a result, there is a tendency to downplay the link between current account deficits and external debt. Moreover, there is also the argument that foreign direct investment enhances productivity and future growth, helping service the foreign liability incurred. In reality, the empirical evidence on foreign direct investment and economic growth is at best mixed (Ghosh and Wang, 2010).

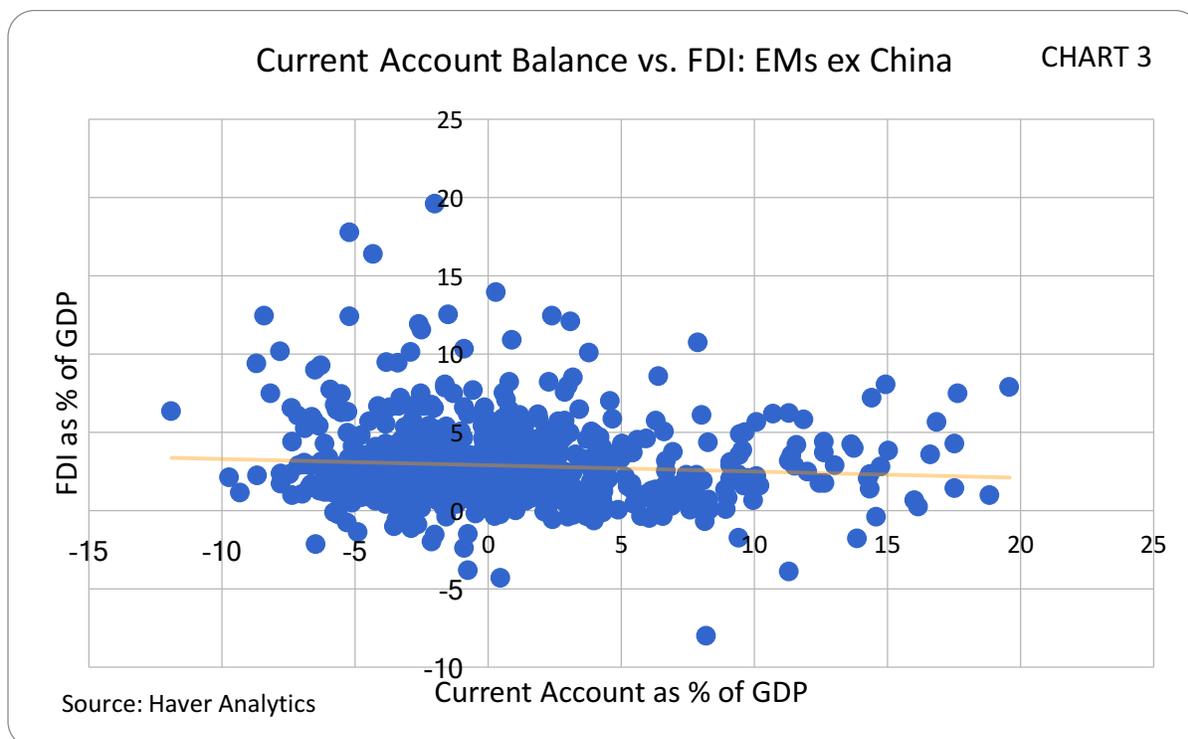


The equating of foreign direct investment with current account deficits comes from the mistaken understanding that if domestic investment is greater than domestic saving—which is equivalent to running a current account deficit—then foreigners must be carrying out part of the domestic investment. A simple example refutes this fallacy. Consider Spain: From 2000 to 2008, when Spain was running a widening current account deficit, it was simultaneously undertaking more direct investment abroad than the flow of FDI into Spain (chart 1)—net direct investment here is shown as direct investment abroad less foreign direct investment at home. Spain is not an outlier, the relationship between current account deficits and gross and net foreign direct investment is weak. Charts 2 and 3 show the relationship between current account balances and inward foreign direct investment for developed market (DM) and emerging market (EM) economies, respectively.

The lack of relationship between current account balances and foreign direct investment also illustrates the fallacy of thinking about the economy in barter terms. In a barter economy, the act of saving also represents simultaneously an act of investment in a good. Thus, when countries sell more goods and services than they buy, the presumption is that the surplus countries are investing in deficit countries. In reality, international

trade takes place in financial terms and countries end up acquiring financial claims. How they allocate those financial claims across assets is a portfolio decision whose link to capital investment is tenuous.

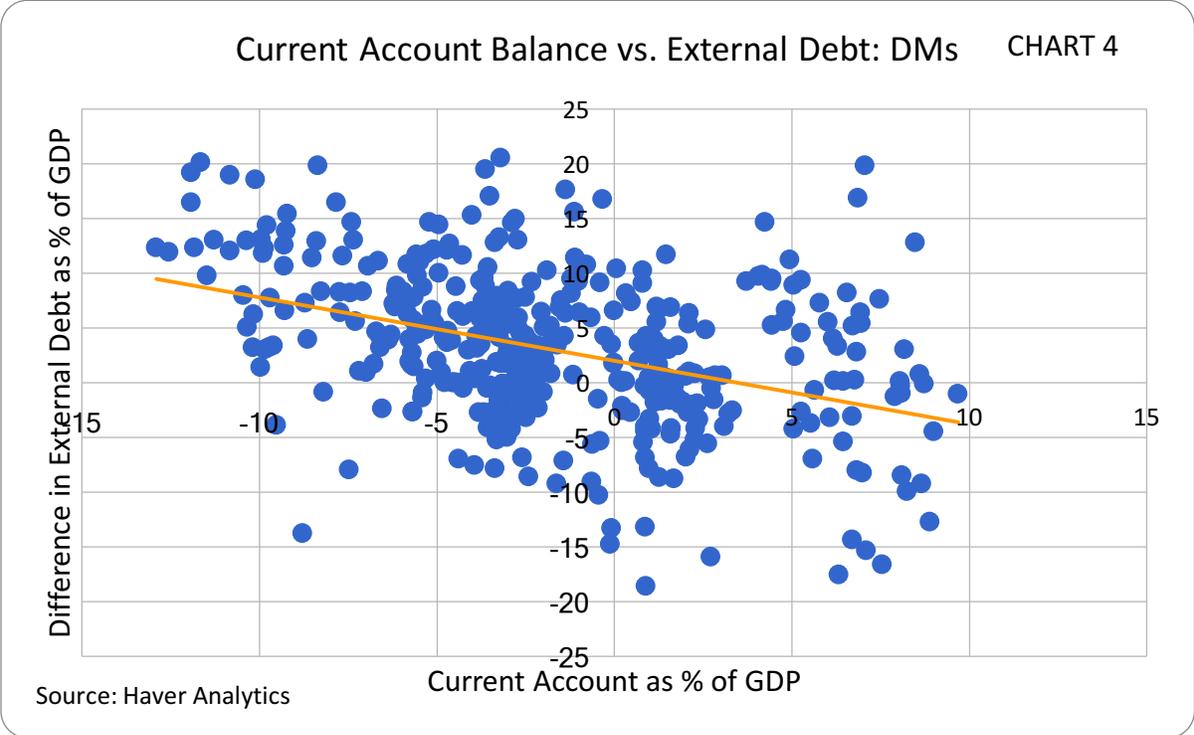


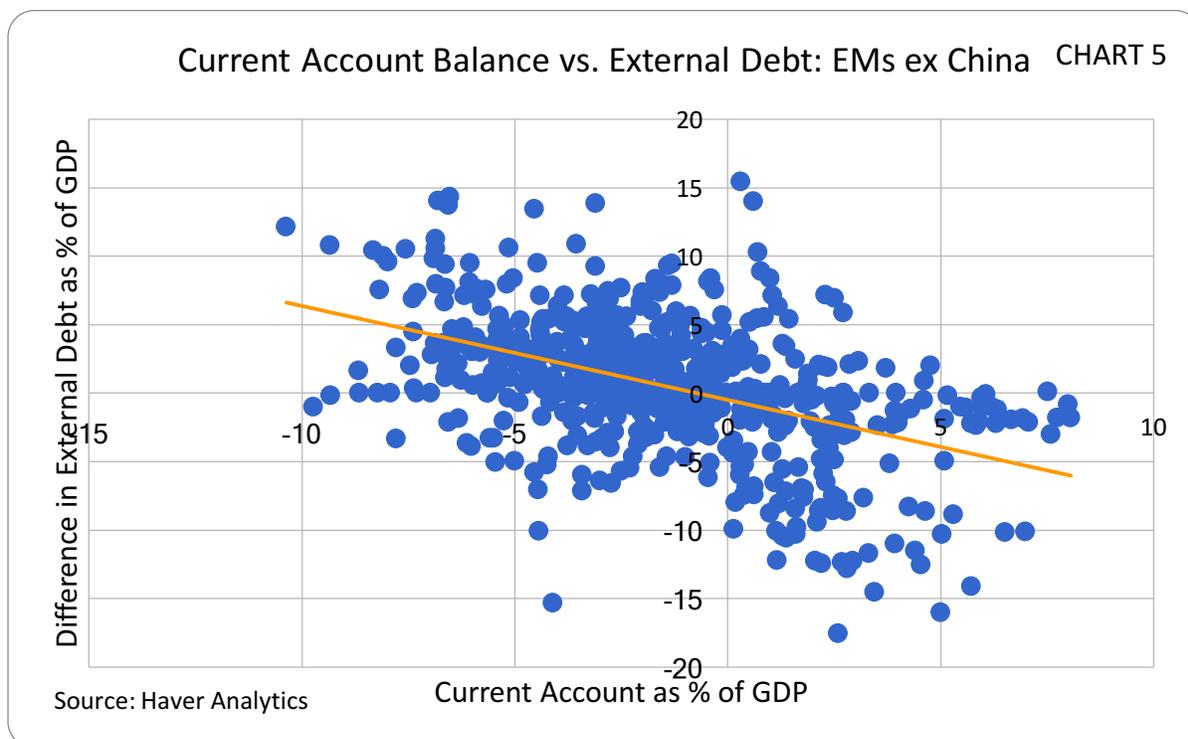


The current account is silent about gross financing flows. All it tells us is that countries running current account surpluses accrue net financial claims on the rest of the world and vice versa. Those net claims happen to be heavily in net debt claims, but more strikingly, even gross external debt claims have a strong positive relationship with the current account deficit (charts 4 and 5). The implication is clear. The current account balance is not a mere symptom. The link between current account deficits and gross external debt is exactly what one would expect when a firm or a person buys goods and services on credit. If the current account deficit arose because of direct investment inflows reflecting strong investment opportunities in the deficit country, then there would be a strong correlation between foreign direct investment and current account deficits and little correlation with external debt. What we see is the exact opposite—the direct investment tail is not wagging the current account dog.

There are other good reasons why current account deficits are associated with external debt. Countries that run current account surpluses tend to either: 1) hold down domestic interest rates and weaken their currencies, eg. Sweden, Switzerland, or 2) run tight domestic fiscal policies, eg. Germany. As a result, either domestic credit creation is weak

or domestic investors are repressed. In either case, investors in these countries have a strong appetite for global fixed income instruments. In the case of EM economies that run perennial current account surpluses, their central banks tend to accumulate reserves, partly to offset currency appreciation; in turn, these reserves are mostly invested in fixed income instruments of developed market economies. These phenomena are part of the so-called global savings glut.



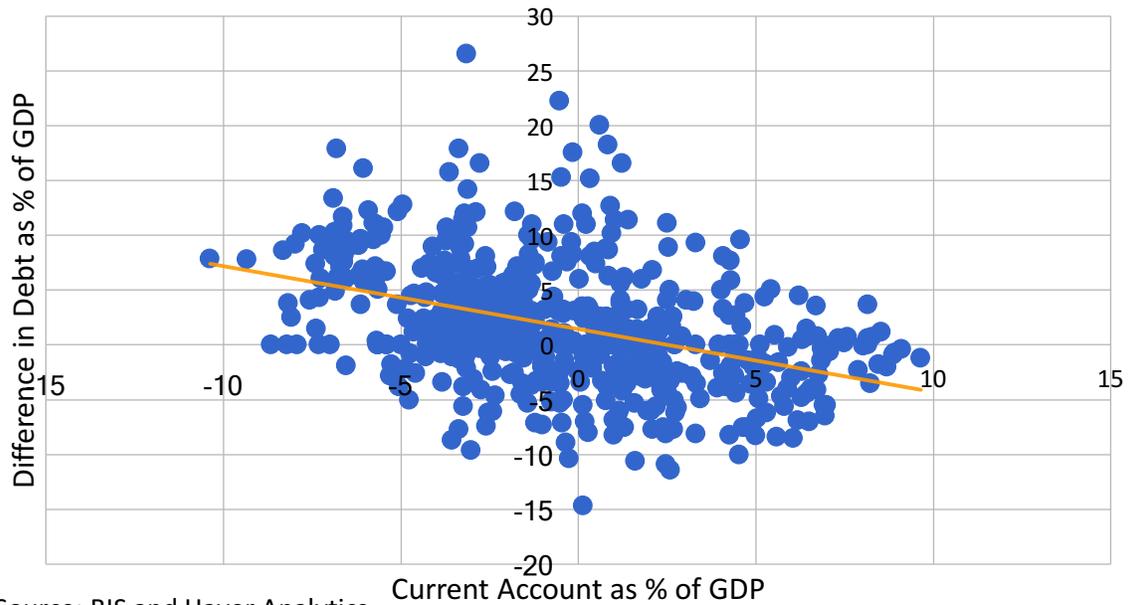


Current Account Deficits and Domestic Debt

While the connection between current account deficits and external debt is often made, especially in discussions of emerging markets, the relationship between current account deficits and domestic debt, especially private sector debt, is consistently ignored. There is a robust negative relationship between current account balances and the change in domestic nonfinancial private sector debt scaled to GDP¹ (chart 6). The relationship is somewhat stronger for DMs (chart 7) than it is for EMs (chart 8), reflecting factors that we discuss in the next section.

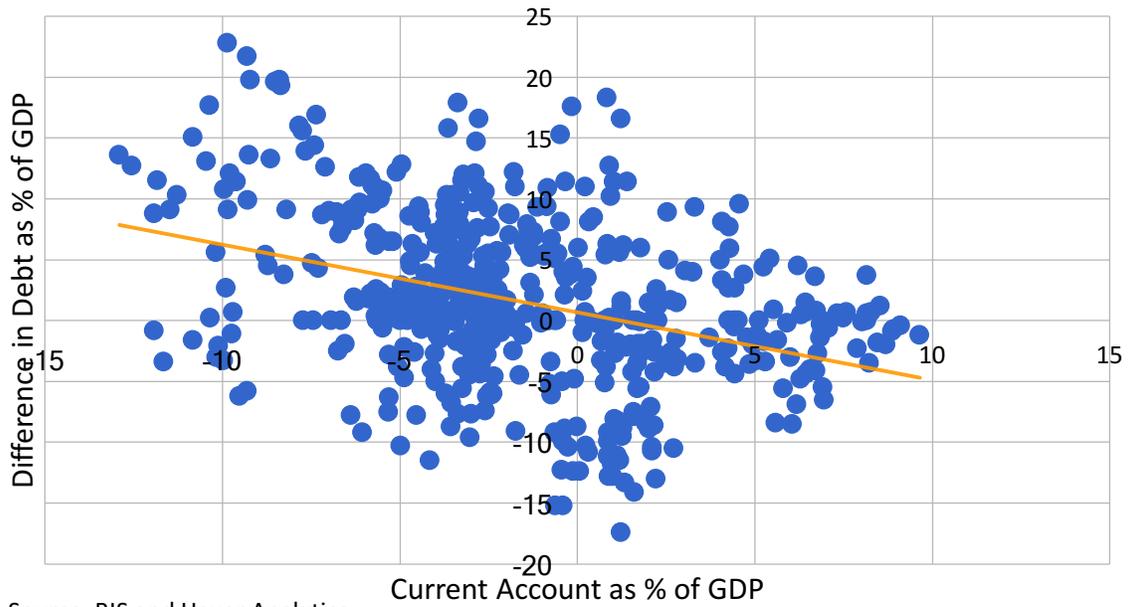
¹ The difference in debt-to-GDP ratio is used here because when pooling disparate countries—especially DMs and EMs—the levels of debt are hugely disparate reflecting many idiosyncratic factors. For countries, the relationship is clear in the levels itself, as I show for a few sample countries below.

Current Account vs. Private Nonfinancial Sector Debt CHART 6



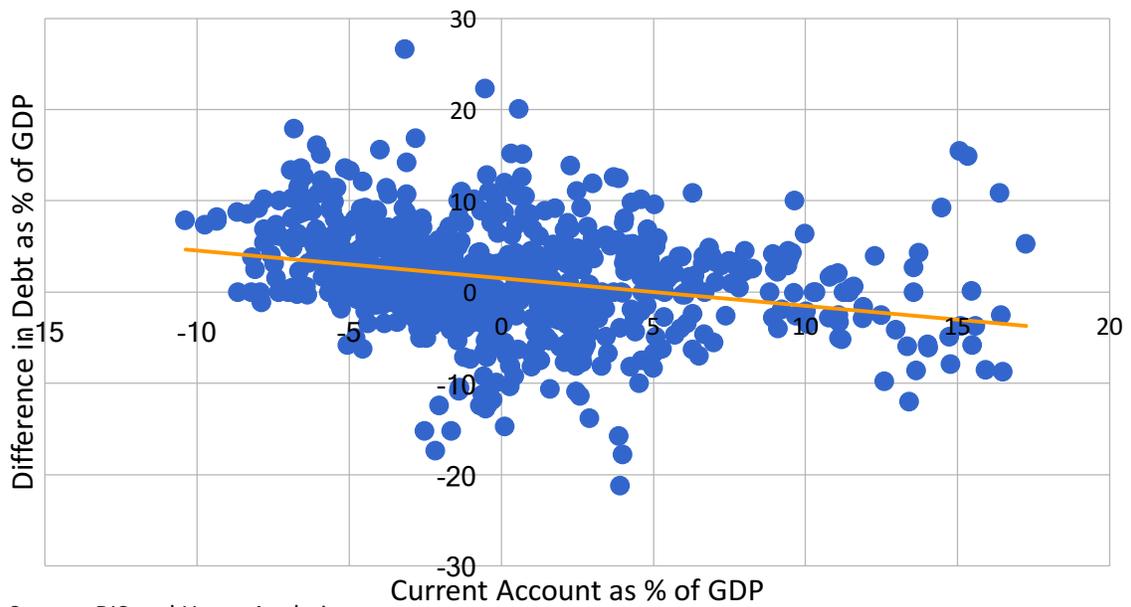
The relationship between the current account balance and domestic leverage is not a mere coincidence. When a country runs a current account deficit, by definition, domestic final demand in nominal terms is growing faster than nominal GDP. In other words, final demand is growing faster than domestic income (which equals GDP); some of the domestic demand “leaks” out to the rest of the world. Demand running consistently higher than income means that some or many sectors of the economy are spending more than the earn, which implies rising debt.

Current Account vs. Private Nonfinancial Sector Debt: DMs CHART 7



Source: BIS and Haver Analytics

Current Account vs. Private Nonfinancial Sector Debt: EMs CHART 8



Source: BIS and Haver Analytics

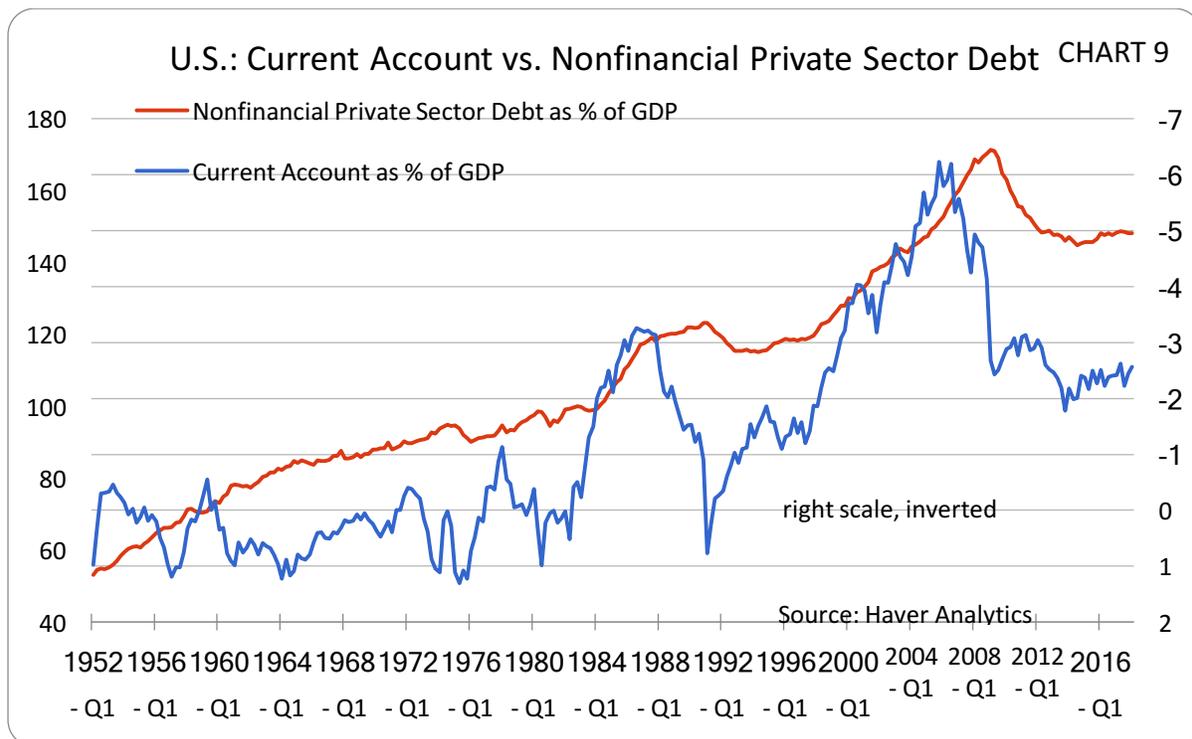
The profits perspective makes it even clearer why current account deficits are associated with rising domestic debt, specifically private sector debt. As noted earlier, a current account deficit is a negative profit source, a drain on profits, which means the other profit sources have to be growing robustly to offset the drag; without rising profits, the economy would not be growing and most likely would be in recession. It is theoretically possible for widening government deficits to offset worsening current account balances and thereby support profits. In practice, fiscal policy in the developed countries in the past 40 years has been passive—tightening during expansions and widening during recessions. So, during expansions, government deficits naturally narrowed. In recessions, when government deficits widened, current account deficits generally narrowed, thanks to falling domestic private demand². Thus, widening current account deficits during expansions were counteracted by strong domestic private profit sources, which in turn meant rising domestic private sector leverage. This pattern has played out in a wide range of countries—the United States, Spain, Australia, the United Kingdom, Canada, Portugal, Ireland—up until the global financial crisis. We will come back to the case of EMs, which needs a separate treatment.

At this point, we have not resolved whether rising domestic leverage causes the current account deficit to worsen or the other way around. In fact, there is a two-way causality. Domestic debt-fueled spending will tend to cause imports to accelerate and—unless the economies in the rest of world are experiencing accelerating domestic demand simultaneously—outstrip exports. Consequently, the trade deficit will widen. On the other hand, if the current account deficit worsens due to global economic conditions—austerity policies abroad, mercantilist policies pursued by some countries—then domestic policy efforts to support the domestic economy will tend to cause private sector leverage to rise, especially when business cycle management is the sole preserve of monetary policy. With active fiscal policy out of the picture, the weakness in profits due to a worsening current account deficit would result in a soft economy. Monetary policy would then attempt to spur the economy through easing policies, effectively encouraging re-leveraging by the private sector.

² As an aside, this is the main reason why the Twin Deficits hypothesis does not hold up.

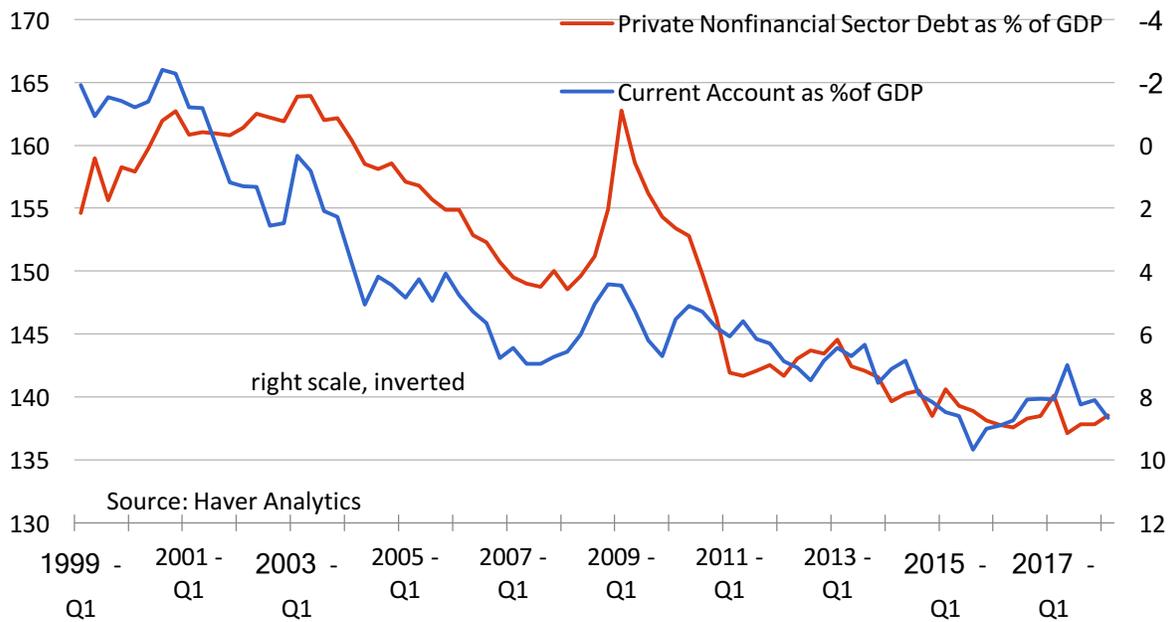
Let us see how this has played out in some notable cases in recent years. Consider the United States. Up until 1980, the United States generally ran a balanced current account (chart 9). The current account turned structurally negative in the early 1980s. Not coincidentally, private sector debt relative to GDP experienced a secular rise from 1980 through 2005. Also note that, during the last 35 years, the two periods where the current account deficit improved—the late 1980s and the 2010s—were followed by private sector deleveraging.

The massive widening of the U.S. current account deficit from 1997 to 2005 was triggered by the series of crises in EMs starting with the Asian crisis. These crises not only crushed demand in EMs and thereby hampered U.S. exports but also induced EMs to build up a war chest of foreign currency reserves to forestall painful currency crises and interventions by the IMF. The build-up of reserves—necessarily implying slowing down currency appreciation in EMs—further dampened global demand, exacerbating global slack, which was misinterpreted by Ben Bernanke as a global savings glut (Bernanke, 2005). Weak inflation and domestic slack, despite a widening current account, meant that the Fed kept interest rates low in order maintain growth. The result was an increase in domestic leverage in the United States.

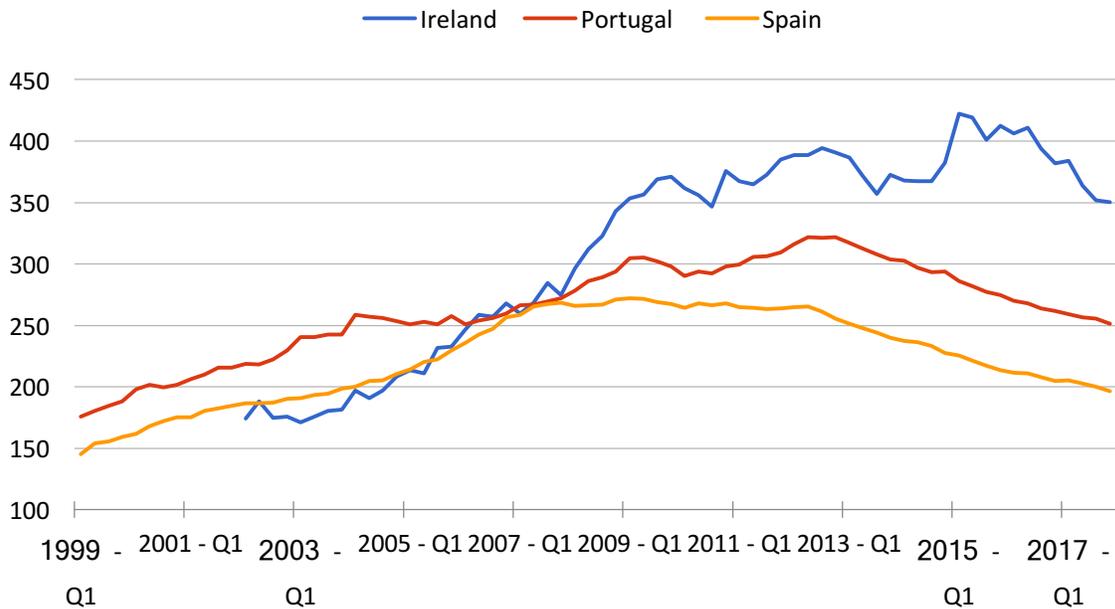


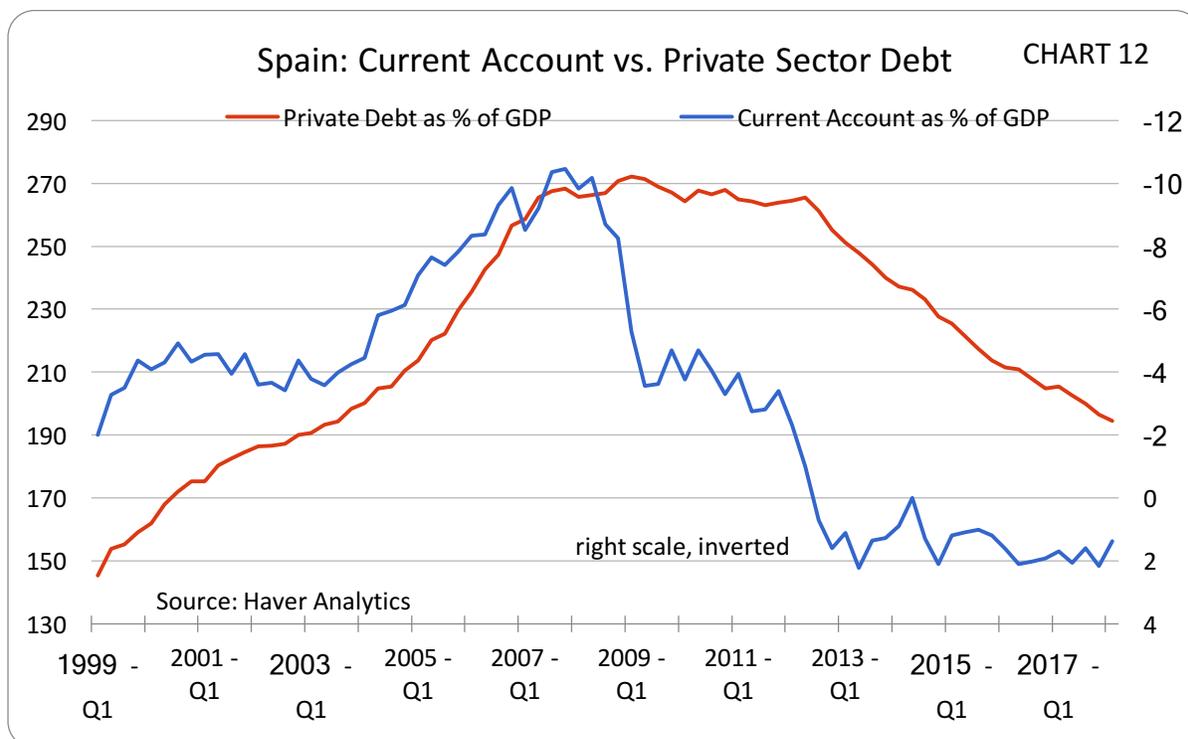
Next, consider Germany. It is hard to imagine today, but Germany in the early years of the euro was a laggard in the euro area, not only growing slower but also having a higher unemployment rate than the region as a whole. Germany also ran a moderate current account deficit until 2001. More important, from a balance sheet perspective, Germany was struggling with high levels of domestic private sector debt. No wonder Germany was once called the sick man of Europe. German policymakers set about to address these problems by restoring competitiveness through the Hartz reforms. The reforms slowed the growth of labor costs, increasing competitiveness, but, in turn, depressed domestic demand. Germany turned into a surplus country and the surpluses kept growing. The improvement in the current account led to a steady decrease in private sector leverage. Chart 10 clearly shows that current account improvement led deleveraging. In other words, Germany was able to export its way out of its balance sheet recession. It also helped that the formation of the euro area and the convergence of borrowing rates across the eurozone allowed countries like Spain, Portugal, Greece, and Ireland to run-up private debt (chart 11), goosing spending and accommodating Germany's expanding trade surplus. Strikingly, Spain too has followed a similar path after the euro area sovereign debt crisis—a dramatic improvement in the current account has allowed private sector deleveraging (chart 12).

Germany: Current Account vs. Private Sector Debt CHART 10



Nonfinancial Private Sector Debt as % of GDP CHART 11





The Case of Emerging Market Economies

“Here’s the script: start with a country that, for whatever reason, became a favorite of foreign lenders, and experienced a large inflow of foreign capital over a number of years. Crucially, the debt thus incurred is denominated in foreign currency, not domestic.”—[Paul Krugman, August 11, 2018](#)

Paul Krugman, writing about the Turkish crisis, recognizes the problem of external debt, but there is not one mention of the term current account or trade deficit in the entire article (Krugman, 2018). It is as if the current account deficit is not even a symptom—very much in line with Adam Smith’s dismissal. Give the history of balance of payments (BOP)-crises in EMs, most market practitioners and policymakers are more alert to the risks of current account deficits in EMs. Nonetheless, there is not much understanding of how the BOP acts as a long-term constraint on EM growth and constrains EMs policy choices in managing the business cycle.

While EMs display many of the same broad patterns as DMs, there are important differences. The variance in the patterns between EMs and DMs is driven by key differences in their fundamental characteristics. EM currencies are generally not hard currencies. As a result, EMs cannot finance current account deficits in their own

currencies and EM external debt is largely denominated in foreign currencies. The combination of having to pay for imports in foreign currencies and having external debt in foreign currencies leads to the endemic threat of currency crisis, which fundamentally alters the domestic policy space and growth strategies. When an EM country grows fast, its imports will also tend to rise rapidly. Unless its exports keep pace, the current account balance will worsen. As we have seen, a worsening of the current account balance will tend to lead to an increase in external debt. International capital markets can accommodate large increases in external debt, but when they become jittery, external debt denominated in foreign currencies stokes a BOP crisis. Thus, EM countries that grow faster than their exports for an extended period of time run the risk of a major currency crisis. In other words, the BOP places an important constraint on long-run growth in EMs.

From the perspective of the BOP constraint on growth, many EM policies and patterns begin to make much more sense. First, most successful EMs have pursued export-led growth strategies because that is the surest way to ease the BOP constraint on growth. To relax the BOP constraint, a country does not need to run current account surpluses; rather, it needs exports to grow rapidly enough that the current account deficit does not balloon, and external debt scaled to GDP remains contained.

Second, to encourage sustainable growth, EM countries generally should encourage foreign direct investment as a way of plugging current account deficits rather than borrowing in foreign currencies.

Third, almost all EMs have built large foreign exchange reserves to avoid BOP problems, especially since the Asian Crisis. In most EMs, the reserves-to-external-debt ratio is now much higher than in the 1990s.

Fourth, EM policies tend to be procyclical. The perennial threat of disorderly declines in currency values tends to make EM sovereign debt denominated in their own currencies less of countercyclical financial asset, reducing the fiscal space for EM governments to conduct countercyclical policy. Thus, EM total nonfinancial sector debt, rather than just the private sector debt, is tightly correlated with the current account balance. A high sensitivity of inflation to currency weakness makes EM monetary policy procyclical as well.

Given this background, it is clear why globalization, especially the period 2000-08, was so beneficial for EMs. Globalization allowed EM exports to DMs to grow exponentially, relaxing the BOP constraint. Moreover, increased capital flows allowed EMs to build their foreign currency reserves, further weakening the BOP constraint. The process of building reserves also fueled demand for safe assets, depressing yields in DMs and extending the unsustainable process of debt-fueled growth in the DMs.

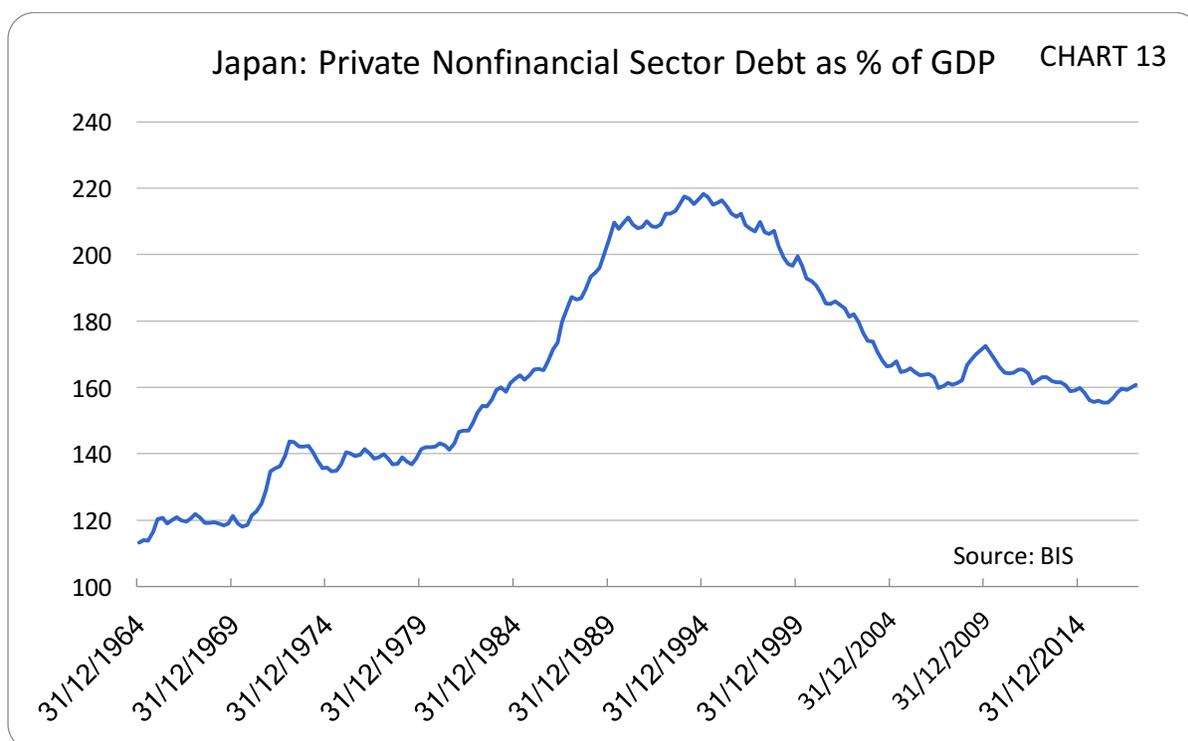
However, the EM boom of the 2000s was in part supported by an unsustainable debt-driven growth in the DMs. Thus, when the financial crisis of 2008-09 forced DMs to deleverage, it undermined a key pillar of EM growth. The weakness of DM growth post-2008 and the plateauing of offshoring and outsourcing meant that EM export growth hit a wall. Initially, EMs were able to counteract these headwinds by running large fiscal deficits and by turning to domestic profit sources. As we have seen in a previous section, domestic profit source growth requires domestic credit creation. Unsurprisingly, EM credit growth exploded post-2008, and not just in China. The limits of EM domestic demand-driven strategy were reached sometime in 2012-14, and since then EM economies have been struggling.

Explaining the Paradox of Japan and China

Japan since 1980s and China since 1994 have run perennial current account surpluses. Yet both countries have experienced massive private sector debt problems. While the coexistence of these two trends may appear contradictory, in both countries it is a manifestation of a greater financial imbalance in the domestic economy.

Japan's explosion in private sector leverage occurred in the 1980s (chart 13), accompanying its bubble economy. In the 1980s, Japanese firms were investing as if the high growth rate of the previous three decades could be sustained indefinitely. However, the growth rate from 1950 to 1980 represented a country that was making a transition from a middle-income country to a high-income country. By 1980s, this high rate of investment was clearly unsustainable. The result was rising corporate sector leverage and stagnating profitability. While the process may have reached a denouement by the mid-1980s, the appreciation of the yen sparked by the Plaza Accord and banking and financial sector deregulation inflated a massive bubble in stocks and real estate, causing leverage

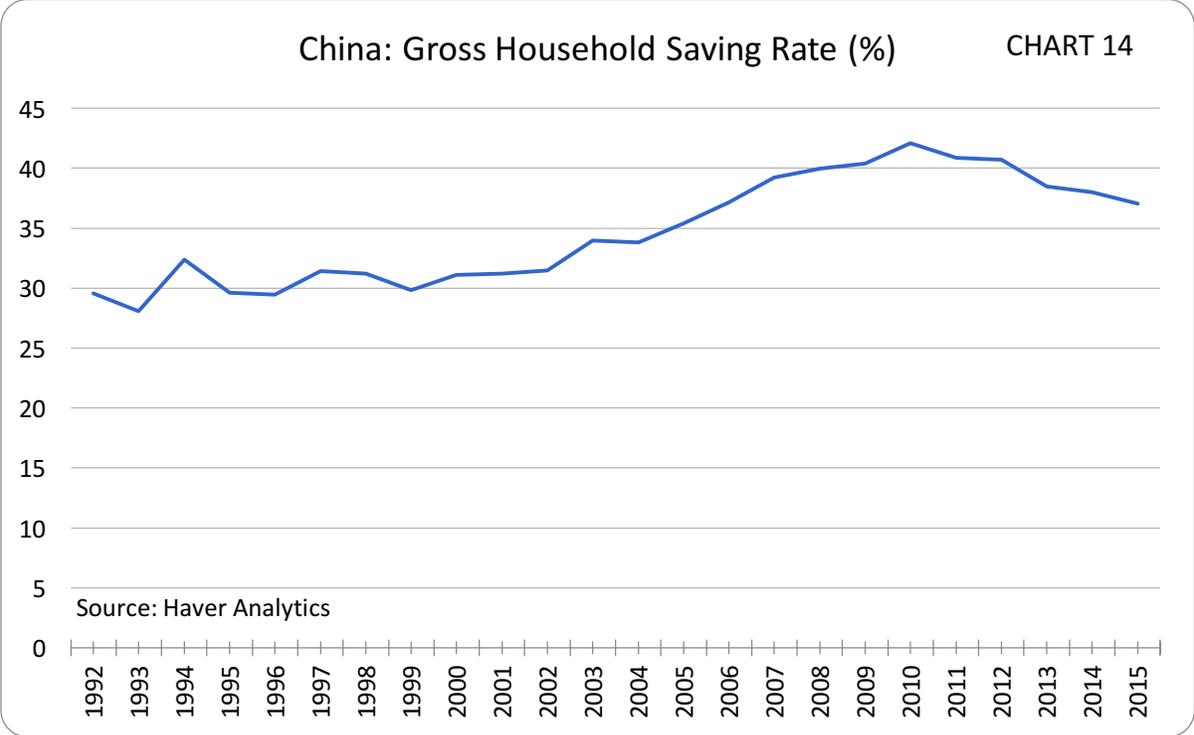
to explode. Since the bubble burst in the early 1990s, Japan has been dealing with domestic private sector deleveraging, a process that has been largely accommodated by rising government debt. However, current account balance has also helped in Japan's deleveraging process. Especially during the peak deleveraging phase from 1996 to 2004, Japan's current account surplus widened significantly.

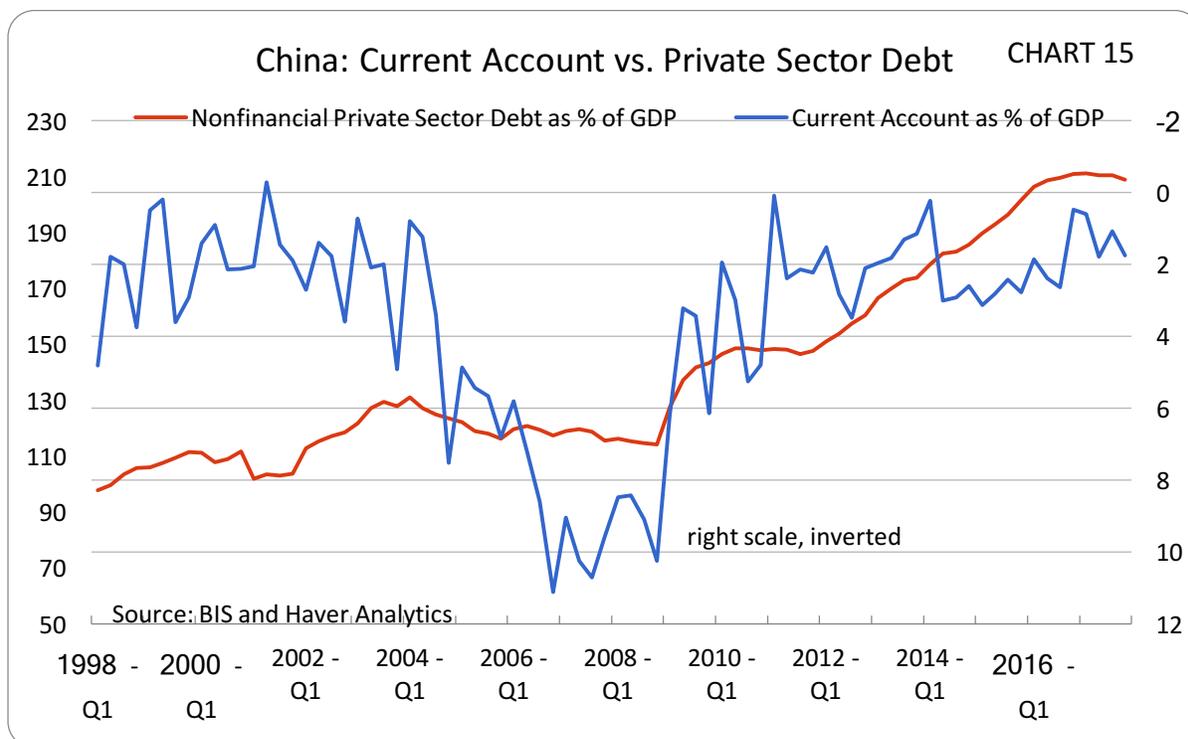


China's imbalances stem from the extraordinarily high saving rate of the household sector (chart 14). The sector financial balances framework, which aggregates households and private nonfinancial corporations, does not illuminate the consequences of a high household saving rate. However, the profits perspective does. High household saving implies a large drag on profits. So, other sectors must make up for it for the economy to have growing profits. In China's case, historically it has been the combination of a high rate of investment and a large current account surplus that has supported aggregate corporate profits. However, the combination of high investment and high household saving means that firms are large net borrowers. Thus, the ballooning corporate sector debt.

Looking at this from the flow of income may provide better intuition. If households are saving at a high rate, it means that less of the compensation paid to them flows back

to firms as demand for goods and services. Firms make up for some of this shortfall in final demand by their own investment demand. However, that results in capacity growing faster than final consumer demand and firms running negative free cash flows. The shortfall in final demand and the chronic excess capacity in China is an important reason why Chinese firms and policymakers are motivated to seek exports. Not only does it partly explain China's quasi mercantilism, but it also explains the deflationary influence on the global economy.





Although China’s high household saving is a dominant influence on its domestic debt dynamics, the trajectory of current account balance helps explain many nuances in its private debt trend—especially the explosive rise in private debt since 2009. First, note from chart 15 that the large run-up in the current balance, coinciding with China’s entry into the World Trade Organization, which enabled it to maintain its growth rate while bringing down private sector leverage. However, this deleveraging was accomplished by saddling the rest of the world with rising leverage. Following the Great Recession, China, like most EMs has experienced weaker exports and a worsening current account balance. The dwindling current account surplus has gone hand in hand with an explosive rise in private debt, consistent with the analysis in this paper. Not surprisingly, China suddenly seems highly vulnerable to the trade war threat.

Global Trade Regime Needs Urgent Reform

*“There is no **orthodox** means open to the authorities for countering unemployment at home except by struggling for an export surplus and an import of the monetary metal at the expense of their neighbors.” John Maynard Keynes [emphasis mine]*

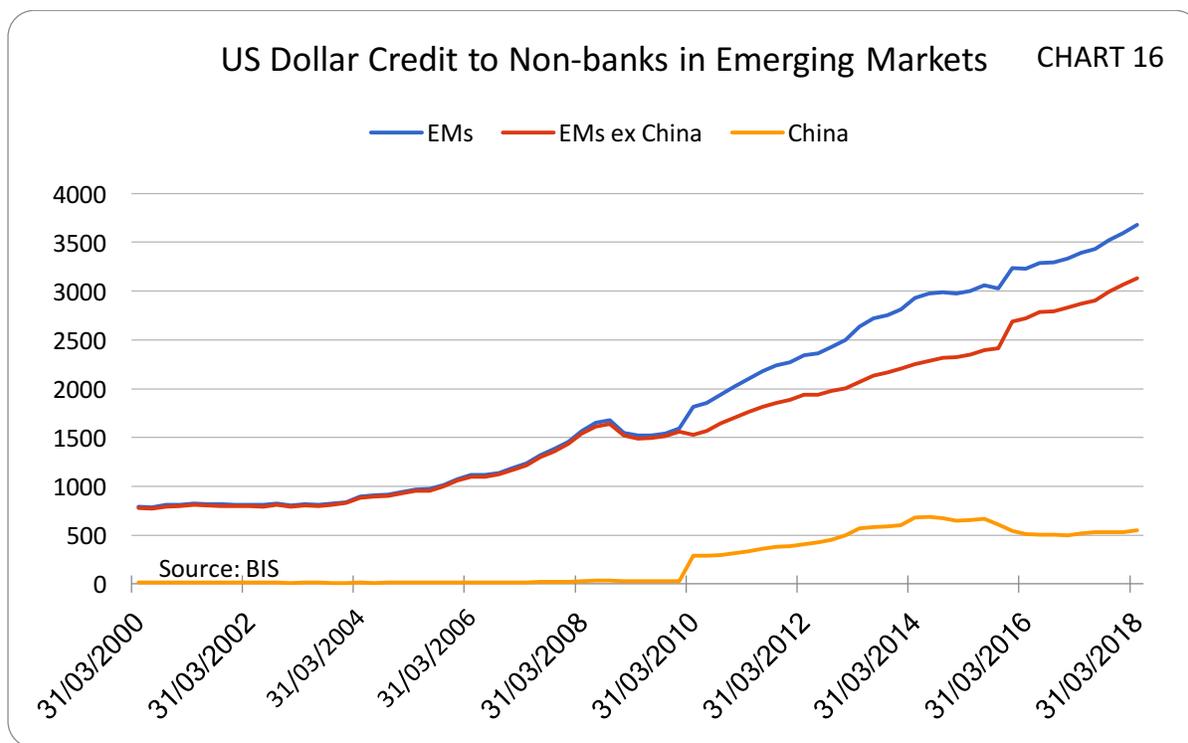
*“Neo-mercantilist policies alleviate the secular stagnation of the country pursuing them by exporting savings, but at the expense of the trading partner.”
Eggertsson, Mehrotra, and Summers*

Over the past 30 years, the global economy has experienced rising debt levels, reflecting partly the reliance on monetary policy for demand management. During this time, we have seen one country or another “use” trade as a way of alleviating problems arising from rising domestic leverage. In the early 1990s, China, struggling with a domestic debt problem and bulging nonperforming loans in the banking system, devalued its currency by 50%. The implications of such a policy are clear from the discussion of sector financial balances from the profits perspective in this paper. They illustrate the point made by Summers and his co-authors in the quote above (Eggertsson, Mehrotra, and Summers, 2016). Whether the Chinese devaluation in the early 1990s led to the Asian Crisis or not, it likely contributed to it. In turn, the countries affected by the Asian Crisis, solved their economic crises by running up large current account surpluses, pushing the problem to other countries. Meanwhile, Germany, struggling with its secular stagnation in the early 2000s, too shifted the burden of its adjustment to other countries, mostly in the euro area. Following the euro area sovereign debt crisis, the countries in the periphery undertook their domestic debt adjustment by passing the problem on to other countries. This time the recipients of the problem were the EMs, who experienced a sharp deterioration of their current account from 2011-2013 as the euro area worked its way out of trouble. The world has come a full circle since 1998. In short, the burden adjustment has been a game of musical chair.

In the absence of global coordination on fiscal and monetary policies, the present international trade and capital flows regime imparts a deflationary bias on the global economy and increases financial fragility. The global economy is caught in a prisoner’s dilemma type situation. In a world of free trade, no country can independently pursue full employment policies at home without experiencing a deteriorating current account balance and rising domestic and external debt ratios. Consequently, as Keynes noted 80 years ago, countries that pursue mercantilist policies have an advantage over those that don’t. On the other hand, the pursuit of mercantilism is not easy for all countries, as deflationary policies at home are not the most politically feasible options in many

countries—especially democracies. Austerity policies have stoked widespread discontent and populist sentiments in many countries.

The uneasy coexistence of free trade internationally, mercantilist policies in some countries, stimulative policies in others, and pressure from international capital for sustainable current account balances is ultimately unworkable. The present U.S. administration has already served notice on the international trade framework, and it may not be long before other countries start to see that they are not benefiting from the current regime. The EMs have been severely affected, with their current account balance worsening since the onset of the euro area crisis. As a result, EMs have experienced a steep rise in dollar-denominated debt (chart 16). With monetary policy tightening in the U.S., there is a growing risk of a dollar-funding crisis in emerging markets.



So far, EMs have been supportive of free trade, but that support may not last. As EMs increasingly come to realize that they are at risk of falling into a new debt trap and that their exports cannot grow as rapidly as before, constraining their growth, they may start to look for other ways to relax the BOP constraint. They may increase tariffs or pursue

other means of reducing imports. For instance, the Indian government has recently made some protectionist moves.

Amid brewing trade wars, as economists are scrambling to protect free trade, their fundamental assumptions remain firmly grounded in the notion that there is nothing so wrong in the present global trade and capital flows regime that it cannot be fixed with a few minor tweaks. The idea that the current account balance is an irrelevant accounting artifact or at best a barometer of other underlying problems continues to be the underpinning of orthodoxy. Yet, international payments imbalances can cause severe problems not just for individual countries but for the stability of the global economy.

Just as the financial crisis highlighted the need for macroprudential measures in macroeconomic management, the global trading framework needs to incorporate a mechanism for dealing with current account imbalances. Most importantly, the burden of adjustment cannot be entirely thrust on the shoulders of the countries running deficits.

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